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# COMPETITION IN THE AIRLINE INDUSTRY

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GOV'T.  
DEPOSITORY

HEARING NOV 23 1993

BEFORE THE

SUBCOMMITTEE ON

ECONOMIC AND COMMERCIAL LAW

AMERICAN LAW LIBRARY

OF THE

COMMITTEE ON THE JUDICIARY

HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

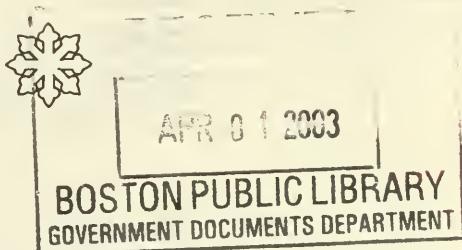
FIRST SESSION

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JUNE 9, 1993

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**Serial No. 8**



Printed for the use of the Committee on the Judiciary

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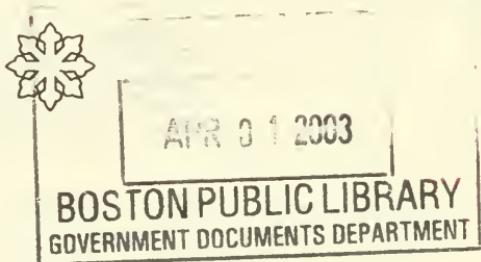
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# COMPETITION IN THE AIRLINE INDUSTRY

WEDNESDAY, JUNE 9, 1993

HOUSE OF REPRESENTATIVES,

SUBCOMMITTEE ON ECONOMIC AND COMMERCIAL LAW,

COMMITTEE ON THE JUDICIARY,

*Washington, DC.*

The subcommittee met, pursuant to notice, at 10 a.m., in room 2141, Rayburn House Office Building, Hon. Jack Brooks (chairman of the subcommittee) presiding.

Present: Representatives Jack Brooks, Mike Synar, Patricia Schroeder, Dan Glickman, Howard L. Berman, David Mann, Melvin L. Watt, Hamilton Fish, Jr., Elton Gallegly, Charles T. Canady, Bob Inglis, Bob Goodlatte, and Carlos J. Moorhead.

Also present: Cynthia W. Meadow, counsel; George P. Slover, assistant counsel; Perry Apelbaum, assistant counsel; Carrie Bedwell, assistant counsel; Catherine S. Cash, research assistant; Deloris L. Cole, office manager; full committee staff: Jonathan R. Yarowsky, general counsel; Daniel M. Freeman, counsel; Alan F. Coffey, minority chief counsel; Charles E. Kern II, minority counsel; Peter J. Levinson, minority counsel; Kevin Cooper, intern; and Ed Robertson, intern.

## OPENING STATEMENT OF CHAIRMAN BROOKS

Mr. BROOKS. The subcommittee will come to order.

The subcommittee meets today to consider the state of competition in the airline industry.

I must confess that I came to this hearing with a little regret as well as a sense of *deja vu*. Fifteen years ago there were high hopes that the bold, new initiative of airline deregulation would finally free U.S. carriers from rigid regulatory controls and inject a new spirit of competition in an industry that too long had catered to a select class of passengers. At that time, I, too, shared these hopes, but they were tinged with some nagging doubts about the speed and the magnitude of the change contemplated.

The promise of a new age seemed borne out in the years immediately following the move to deregulation. A flurry of new, innovative carriers entered the market, offering increased routing choices and lower fares. These upstarts gave the established carriers a needed jolt, and air travel became an exciting new option for millions of Americans who had been mere spectators to air travel for decades.

But within a few short years, the promise of a new era fell victim to the frenzy of mergers, takeovers, and leveraged buyouts that swept over the industry, leading inevitably to a succeeding wave of

bankruptcy, reorganizations, and liquidations. Unfortunately, the Reagan-Bush administrations hardly lifted a finger to enforce the antitrust laws in this sector.

With no regulation and no antitrust, the end result was that the new competitors disappeared almost as rapidly as they surfaced. Equally troubling, established carriers with long, distinguished traditions of service disappeared as well.

The consequences were dire indeed. Besides a reduced number of competitors, a steep decline in employment accompanied these changes. Sadly, the industry has lost more money in the last 3 years than the cumulative profits achieved since the Wright brothers flew over Kitty Hawk for the first time in 1903.

While there is widespread agreement that the airline industry is now deeply troubled, there is surprisingly little consensus over the appropriate response. And I praise President Clinton for recognizing the problem early in his administration and appointing a commission to study the situation and develop some recommendations.

Yet, Congress, which went along with the move to deregulate 15 years ago, now cannot afford to take a completely passive role in overseeing what is one of the most vital segments of the American economy.

We have a diverse and impressive group of witnesses to offer to the subcommittee their insights on the competitive health of the modern airline industry. We welcome you and look forward to your testimony.

Mr. Fish, the gentleman from New York.

Mr. FISH. Thank you, Mr. Chairman.

This hearing reflects the fact that the present difficulties facing the airline industry are receiving the attention they deserve from Congress—not only from this subcommittee but from the Public Works Aviation Subcommittee as well as the recently created national commission which has been charged to come up with recommended solutions within 90 days.

I believe that the antitrust law and bankruptcy law perspectives of the Economic and Commercial Law Subcommittee will be particularly valuable in this process. This is because so much of what is happening and has happened in the industry relates to establishing and preserving an environment in which the parties can compete on equal terms and the consumer will benefit from lower prices and improved service. I can recall, as you have, in fact, the very useful hearings on mergers and competition in the airline industry that this subcommittee held in 1986.

The competitive and financial turmoil which has beset the aviation industry for some time has been ascribed to many causes—worldwide recession, rising fuel cost, leveraged buyouts, and aircraft overcapacity. The sharp decline in the number of major airlines from 22 when deregulation took effect in 1978 down to just 10 carriers today—3 of them just emerged from a bankruptcy—is a far cry from the optimistic expectations of 15 years ago. At that time the theory of contestability held that since an airline is the most mobile of all business assets, a carrier could easily and cheaply enter a market characterized by high prices or inferior service simply by redeploying the aircraft. Unfortunately for this theory, as one critic has observed, a plane must also take off and land. That

is, the availability of landing slots substantially affects the "ease of entry" in this industry.

This morning we will be hearing about overcapacity, barriers to entry and growth, bankrupt carriers, and numerous other related issues and factors. I am confident we will be able to draw considerable wisdom from the testimony of our witnesses. And I hope this subcommittee will continue to make a positive contribution to public policy in this area.

Thank you, Mr. Chairman.

Mr. BROOKS. Thank you very much, Mr. Fish.

To expedite matters, I request that the witnesses summarize their statements within 5 minutes, and after the witnesses have completed their statements, the subcommittee will address questions. Prepared statements will be made in their entirety a part of the record. I don't mean that book Dempsey wrote, not the whole book.

Without objection, the hearing record will remain open to receive additional witnesses.

The first witness will be Mr. Robert L. Crandall, who is chairman, president, and chief executive officer for AMR Corporation and American Airlines.

The next member of that panel will be Robert R. Ferguson III, president and chief executive officer of Continental. He has given tremendous leadership to Continental, and as a result, the airline recently emerged from bankruptcy reorganization proceedings.

The third witness on the panel is Arthur M. Luby, general counsel of the Transport Workers Union of America, the largest union associated with American Airlines. Mr. Luby is also appearing here today own behalf of the AFL-CIO.

It is a pleasure to have the three of you. If you would come forward and sit down, it is a pleasure to have all of you take time out of your busy schedules to be here, and we will start with Mr. Crandall.

**STATEMENT OF ROBERT L. CRANDALL, CHAIRMAN, PRESIDENT, AND CHIEF EXECUTIVE OFFICER, AMR CORPORATION AND AMERICAN AIRLINES, INC.**

Mr. CRANDALL. Thank you, Mr. Chairman, members of the subcommittee.

I am very pleased to be here today and to give you our views on the subject of how the U.S. bankruptcy laws, particularly the statutory changes that were made in 1978 and the administrative changes that have been adopted since, have contributed to the widely known financial troubles of the U.S. airline industry.

I think there is great irony in the fact that in the same year that Congress enacted the Airline Deregulation Act of 1978, it also adopted amendments to the Bankruptcy Act which, as construed by the bankruptcy courts, have severely distorted the competitive airline marketplace that deregulation sought to establish. In the process, successful and prudent competitors have been penalized for the benefit of the less successful.

The airline industry, to a far greater extent than most businesses, provides consumers with nearly perfect information about the price and service alternatives offered by every competitor. The

computerized reservations systems created in the late 1970's have become universally available cornucopias of travel facts, providing travel agents and consumers instantaneous access to complete information about every airline's prices, schedules, and seat availability. I know of no other product about which consumers have as much readily available product information, and of very few products to which consumers give so little brand loyalty.

Those factors have created an intensely competitive business in which every airline strives desperately to offer prices and schedules equal to those offered by any other.

Now, some argue that the industry's problem is simply a consequence of overcapacity. But the fact is that because flight frequency is so important to consumers, a competitive, scheduled transportation system will always offer more capacity than is actually needed.

Moreover, as long as the bankruptcy laws permit capacity which has been rejected by the marketplace to continue operating, there is no opportunity for the laws of supply and demand to bring about the reduction of capacity that one would normally expect in a market-driven business. Nonetheless, the industry has no more capacity relative to demand today than it has had in more prosperous times.

During 1988, a year in which airlines earned record profits, the industry filled 62.5 percent of its seats. Last year it filled 63.7 percent. However, between late 1988 and the end of last year, the industry's average price per seat mile, which we call yield, declined by 15 percent in real terms.

Very simply, the industry's constant price wars have deprived it of the ability to balance costs and revenues, and it is the bankrupt and overleveraged airlines that are leading prices downward.

The chapter 11 carriers initiated 55 percent of all fare reductions during the past 12 months, and if fare cuts initiated by financially ailing Northwest are included, that number rises to 84 percent.

The willingness of the failed and failing carriers to cut prices is rooted in their desire to fill seats and in the huge cost differences between themselves and the nonbankrupt carriers. Those cost differences are the result of concessions extracted from both creditors and employees.

Creditors make concessions because of the bankrupts' ability to reject contracts, which gives them enormous leverage. Employees agree to wage and benefit givebacks because of their understandable concern that absent concessions, the company may go out of business altogether. And the numbers involved are enormous.

Continental, which used its first bankruptcy filing in 1983 to slash the wages of some employees by as much as 50 percent, continued ratcheting wages and benefits downwards through the tenure of its second bankruptcy, which began in 1990.

Today, the cumulative effects of Continental's many wage and benefit cuts is a compensation structure which gives it an annual labor cost advantage relative to American of more than \$1.5 billion.

Industrywide, compensation per employee at the bankrupt airlines is about 25 percent less than at nonbankrupt carriers, and the overleveraged carriers are continuing to seek more wage and benefit concessions. And as that process goes on, the healthier car-

riers, which provide the high-quality, well-paid, full-benefit jobs that our economy needs, find themselves at an ever-growing competitive disadvantage.

All of this, and the price cutting which those cost cuts encourage, has led to huge industry losses. According to a recent study by Aviation Forecasting and Economics, "Below-cost competition by bankrupt carriers has severely damaged the financial viability of healthy airlines. The spread of this bankruptcy virus has sapped the economic vitality of an entire industry and jeopardizes the success of airline deregulation."

Now, our bankruptcy laws are premised on the notion that allowing a failed company an opportunity to reorganize its affairs and start again is sound national policy. While that may or may not be generally true, the application of that principle has had disastrous consequences for the airline industry.

The industry's continuing huge losses threaten the existence of the financially healthy and competitive industry that Congress sought to create, and about which the National Commission to Ensure a Strong Competitive Airline Industry is now considering recommendations. Our briefing book for that commission, a copy of which is attached, includes a detailed discussion of the adverse impacts of bankruptcy on nonbankrupt carriers.

In my judgment, bankruptcy law as it is applied today is incompatible with the Deregulation Act of 1978—and should be changed in a number of ways. Specifically, we suggest the following changes.

First, restore the pre-1978 prohibition of repeat filings.

Second, require the appointment of a trustee or new management upon the filing of a bankruptcy petition, rather than permitting incumbent management to remain in place. That is particularly important because, according to those who have studied the subject, most airline failures are the consequence of bad management.

Third, limit the length of time that debtors can linger in bankruptcy by setting short and nonextendable limits on the duration of the period of exclusivity and the length of time that may lapse between the filing and the confirmation of a reorganization plan.

And finally, we think the law should deny bankrupts the ability to discharge employee-related obligations, such as pension fund contributions and medical coverage, and should limit their ability to reduce employee compensation.

By making bankruptcy less rewarding, you will reduce the propensity of managers to undertake nonsustainable risks and to propound untenable business plans—and by doing so, you will reduce the number of bankruptcies.

Members of the committee, Mr. Chairman, I appreciate the opportunity to put my views before you today. We stand ready to share our experiences and to work with this committee and the administration to help find a solution to what we think is a very important problem.

Mr. BROOKS. Thank you, Mr. Crandall.

[The prepared statement of Mr. Crandall follows:]

Statement of Robert L. Crandall  
Chairman and President  
American Airlines, Inc.

before the U.S. House of Representatives  
Economic and Commercial Law Subcommittee  
of the Committee on the Judiciary

June 9, 1993

Mr. Chairman ... members of the Subcommittee ... I am pleased to be here today to give you our views about how U.S. bankruptcy law -- and particularly the statutory changes made in 1978, and the administrative changes adopted since -- have contributed to the widely known financial troubles of the U.S. airline industry.

There is great irony in the fact that in the same year the Congress enacted the Airline Deregulation Act of 1978, it also adopted amendments to the bankruptcy code which, as construed by the bankruptcy courts, have severely distorted the competitive airline marketplace that deregulation sought to establish. In the process, successful and prudent competitors have been penalized for the benefit of the less successful.

The airline industry, to a far greater extent than most businesses, provides consumers with nearly perfect information about the price and service alternatives offered by all competitors. The computerized reservations systems created in the late 1970s have become universally available cornucopias of travel facts, giving travel agents and consumers instantaneous access to complete information about every airline's prices, schedules and seat availability. I know of no other product about which consumers have as much readily available product information -- and of very few to which consumers give so little brand loyalty. These factors have created an intensely competitive business in which every airline strives desperately

to offer prices and schedules equal to those offered by any other.

The ferocious competition fostered by consumers who are both well informed and willing to substitute one airline's seat for another's is made even more acute by the inherent economics of our business. Since each flight an airline offers is a unique product, and since airline customers choose between carriers based on price and schedule convenience, each carrier must seek to offer as many flights as any rival on each route and at each hub. And, because every airline's variable costs are very low, and since every unsold seat becomes worthless the instant a flight departs, air carriers are continuously tempted to reduce price to fill their seats.

Some argue that the industry's pricing problem is simply a consequence of overcapacity -- but the fact is that because flight frequency is so important to consumers, a competitive scheduled transportation system will always offer more capacity than is actually needed.

Moreover, so long as the bankruptcy laws permit capacity rejected by the marketplace to continue operating, there is no opportunity for the laws of supply and demand to bring about the rationing of capacity one would normally expect in a market-driven business. Nonetheless, the industry has no more capacity relative to demand today than it has had in more prosperous times. During 1988, a year in which airlines earned record profits, the industry filled 62.5% of its seats. Last year, it filled 63.7%. However, between late 1988 and the end of last year, the industry's average price per seat mile -- which we call yield -- declined by 15% in real terms.

Very simply, the industry's constant price wars have deprived it of the ability to balance costs and revenues -- and it is the bankrupt and over-leveraged airlines that are leading prices downward. The Chapter 11 carriers initiated 55% of all fare reductions during the past 12 months -- and if fare cuts initiated by financially ailing Northwest are included, that number rises to 84%.

The willingness of the failed and failing carriers to cut prices is rooted in their desire to fill seats and in the huge cost differences between themselves and the non-bankrupts.

Those cost differences are the result of concessions extracted from both creditors and employees. Creditors make concessions because of the bankrupts' ability to reject contracts, which gives them enormous leverage. A document Continental filed with the bankruptcy court in January 1993, for example, asserted that Chapter 11 would enable it to reduce "its net annual interest and lease expense by more than \$300 million from levels existing prior to its Chapter 11 filing."

The bankrupts are also able to extract large wage and benefit give backs because of their employees' understandable concern that absent concessions, the company may go out of business altogether. For example, after filing for bankruptcy in June of 1991, America West imposed a 10 percent across-the-board wage cut, an indefinite wage freeze and other compensation changes which reportedly saved it \$100 million. At TWA, pay cuts and work-rule changes obtained since its bankruptcy filing in January 1992 will reduce its costs by more than \$175 million this year.

Continental, which used its first bankruptcy filing, in 1983, to slash the wages of some employees by as much as 50%,

continued ratcheting wages and benefits downward through the tenure of its second bankruptcy, which began in 1990. Today, the cumulative effect of Continental's many wage and benefits cuts is a compensation structure which gives it an annual labor cost advantage versus American of more than \$1.5 billion!

Industry-wide, compensation per employee at the bankrupt airlines is about 25 percent less than at non-bankrupt carriers and the over-leveraged carriers are continuing to seek more wage and benefit concessions. As this process goes on, the healthier carriers, which provide the high-quality, well-paid, full-benefit jobs our economy needs, find themselves at an ever-growing competitive disadvantage.

All this, and the price cutting which these cost cuts encourage, has led to huge industry losses. According to a recently completed study by Aviation Forecasting & Economics -- a copy of which is attached for your reference -- Eastern's price cutting during the two years it spent in Chapter 11 cost Delta, its primary competitor, more than \$700 million.

The same study finds that the pricing initiatives of bankrupt carriers have caused the non-bankrupt airlines to employ 30,000 fewer people than would otherwise have been the case. "Below-cost competition by bankrupt carriers," states the report, "has severely damaged the financial viability of healthy airlines... The spread of this bankruptcy virus has sapped the economic vitality of an entire industry and jeopardizes the success of airline deregulation."

Our bankruptcy laws are premised on the notion that allowing a failed company an opportunity to reorganize its affairs and start again is sound national policy. While that may or may not

be generally true, the application of this principle has had disastrous consequences for the airline industry.

Our industry is subject to both high capital costs and high labor costs, and provides nearly perfect information to consumers. In that environment, the continued operation of failed carriers has thrown out of kilter the essential balance between costs and revenues.

The industry's continuing huge losses threaten the existence of the financially healthy and competitive industry the Congress sought to create, and about which the National Commission to Ensure a Strong Competitive Airline Industry is now considering recommendations. Our briefing book for the Commission -- a copy of which is attached -- includes a detailed discussion of the adverse impacts of bankruptcy on non-bankrupt carriers.

In my judgment, bankruptcy law as it is applied today is incompatible with the Airline Deregulation Act of 1978 -- and should be changed in a number of ways. Specifically, we suggest the following changes:

1. Restore the pre-1978 prohibition on repeat filings.
2. Require the appointment of a trustee or new management upon filing of a bankruptcy petition, rather than permitting incumbent management to remain in place. This is particularly important since, according to those who have studied the subject, most airline failures are the consequence of bad management.
3. Limit the length of time that debtors can linger in bankruptcy by setting short and non-extendable limits on the

duration of the period of exclusivity -- during which no one other than management may make reorganization proposals -- and the length of time that may lapse between the filing and confirmation of a reorganization plan.

4. Finally, the law should deny bankrupts the ability to discharge employee-related obligations, such as pension-fund contributions and medical coverage, and should limit their ability to reduce employee compensation.

By making bankruptcy less rewarding, you will reduce the propensity of managers to undertake non-sustainable risks and to propound untenable business plans -- and by doing so, will reduce the number of bankruptcies.

Mr. Chairman ... members of the Committee ... thank you very much for the opportunity to put my views before you today. We stand ready to share our experiences, and to work with this Committee -- and the Administration -- to help find a solution to what we think is a very important problem.

The two documents attached to Mr. Crandall's statement are too voluminous to be included in the printed hearing record. The documents are entitled:

"The U.S. Airline Industry," American Airlines, Inc., May 1993, 48 pp.

"The Bankruptcy Virus in the U.S. Airline Industry: Causes and Cures," Aviation Forecasting & Economics, 1925 North Lynn Street, Suite 903, Arlington, VA 22209, April 1993, 115 pp., \$195.

Mr. BROOKS. Now we hear from Mr. Robert Ferguson III, Continental.

**STATEMENT OF ROBERT R. FERGUSON III, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CONTINENTAL AIRLINES, INC.**

Mr. FERGUSON. Good morning. I appreciate the opportunity to appear before the subcommittee today to discuss competition in the U.S. airline industry.

I have a more detailed statement which I filed with the committee. Hopefully you will admit it into your record.

First, Mr. Chairman, on behalf of Continental's 42,000 employees, I would like to thank you and your colleagues on the House Judiciary Committee for the quick action earlier this year with respect to the emergency legislation which enabled our bankruptcy reorganization to proceed successfully and timely.

I would also like to quickly address three issues. First, the Justice Department's antitrust lawsuit against the Airline Tariff Publishing Company; capacity; and finally, something, although not necessarily in this committee's jurisdiction, the Global Positioning System.

Last year the U.S. Department of Justice filed suit against eight airlines to resolve alleged allegations of anticompetitive pricing activities. The so-called anticompetitive actions were the airline practice of letting consumers know the expiration date of airfares.

I would like to urge this committee to join your colleagues on the House Aviation Committee, travel agents, and consumer groups in urging the Department of Justice to reexamine their basic decision. The Justice Department's action is bad for our consumers.

As many of you know from planning your own vacations with family and friends, when you call a travel agent or an airline reservation system you are provided with the availability of air service and the price of that service for the time you want to travel. As part of that process you are informed about the length of time a particular fare or discount is available in relevant market segments.

If the Justice Department were to have its way, the customer who makes an inquiry about a fare will be told by the travel agent or reservation agent that the quoted fare is only good for the length of that conversation. Forced to make an instantaneous decision, the customers will have no way of knowing whether they have the best available deal. They could call back in an hour and it might be cheaper, or they could call back in an hour and it might be more expensive, perhaps as much as double.

The uncertainty is unfair to all consumers and denies our customers the basic right to be informed and to be given the facts required to make an informed choice.

On a completely different topic, just last week I served on a panel organized by the National Commission to Ensure a Strong Competitive Airline Industry with the other chief executive officers. The topics of discussion ranged from airline taxes, generally too high; airline profitability, obviously too low. The Government regulations, in our view, too many.

I want to say to you what I said to them. One root cause of the industry's current dismal plight is that there are too many seats

chasing too few passengers. Clearly excess capacity in the industry contributes to our inability to become profitable.

For your information, I have attached several charts in this testimony which demonstrate the origin of excess capacity in the airline industry. These charts clearly show that excess capacity was not so much caused by the obstinate failure of bankrupt carriers to go away, but by the enormous expansion of the so-called big three carriers, resulting in industry overcapacity, which is a significant factor in industry losses.

In 1992, the situation was made much worse by the so-called value pricing fare initiative. 1992 turned out to be the single worst year in airline history.

Finally, a few words about how airlines go from place to place and how they should do that in the very near future. We have been waiting for the FAA to develop the microwave landing system, or MLS. Simultaneously we have been watching millions of tax dollars being consumed in the process.

In the meantime, we already have a constellation of satellites put in place by the Defense Department which, by the use of inexpensive and readily available equipment, will enable our aircraft to travel on land literally within a few feet of their destination.

It is called the Global Positioning System. The potential cost savings to the airline industry alone are staggering.

I would urge the Congress and the airline commission to regard the speedy implementation of GPS as a means of providing financial relief and therefore competitive improvement of our industry. I might add, it will also reduce the U.S. deficit.

I am sure that you and your colleagues have questions about competition in the airline industry. I would be happy to try and answer them.

Again, thank you. I hope I made an on-time conclusion.

[The prepared statement of Mr. Ferguson follows:]

STATEMENT OF ROBERT R. FERGUSON, III  
PRESIDENT AND CHIEF EXECUTIVE OFFICER  
CONTINENTAL AIRLINES, INC.  
BEFORE THE ECONOMIC AND COMMERCIAL LAW SUBCOMMITTEE  
OF THE HOUSE JUDICIARY COMMITTEE  
CONCERNING  
COMPETITION IN THE AIRLINE INDUSTRY  
U.S. HOUSE OF REPRESENTATIVES  
JUNE 9, 1993

Good morning. My name is Robert Ferguson and I am the President and Chief Executive Officer of Continental Airlines, Inc. I appreciate the opportunity to appear before the Subcommittee today to discuss competition in the U.S. airline industry -- certainly we at Continental have a unique view having just successfully emerged from a 29-month bankruptcy reorganization.

Before I begin my formal testimony Mr. Chairman, on behalf of Continental's 42,000 employees, I would like to thank you and your colleagues on the House Judiciary Committee for your quick action earlier this year with regard to the emergency legislation which enabled our bankruptcy reorganization to proceed successfully and in a timely manner.

Mr. Chairman, knowing that you and your colleagues on the subcommittee have a number of questions you want me to address on a variety of aviation issues, I would like to limit my formal testimony to three issues:

1. The Justice Department's suit against the Airline Tariff Publishing Company;
2. Capacity; and
3. Global Positioning System (GPS)

Last year, the U.S. Department of Justice filed suit against the Airline Tariff Publishing Co. and eight airlines. The suit was an attempt to resolve allegations of anti-competitive airline pricing activities by forcing U.S. airlines to cease practices whereby they disclose beginning and expiration dates of air fares. Just six weeks ago, your colleagues in the House Aviation Subcommittee held a hearing on this issue and as a result of the testimony they heard, Chairman Oberstar and Ranking Member Clinger signed a letter (May 5, 1993) to Attorney General Janet Reno in which they stated:

"...we think you should reexamine the basic decision to go forward with this case..."

We agree with Congressmen Oberstar and Clinger because we know that the Justice Department's action is bad for our customers. As many of you know from planning your own vacations with family and friends, when you call a travel agent or an airline reservation system you are provided with the

availability of air service and the price of that air service for the time that you want to travel. As a part of that process, you are informed about the length of time a particular discount is available for the relevant flight segments. If the Justice Department were to have its way, the customer who makes an inquiry about a fare will be told by the travel or reservations agent that the quoted fare is only good for the length of that conversation. Forced to make an instantaneous decision, our customers will have no way of knowing whether they have the best deal available -- they could call back in an hour and it might be cheaper or they could call back in hour and the fare could double. The uncertainty is unfair to all consumers and denies our customers their basic right to be informed and to be given the facts required to make an informed choice.

During the legal proceedings involved with this lawsuit, several hundred travel agents, consumer groups and other travel-related organizations filed comments with the judge opposing the portions of the proposed settlement (a consent decree which at least two airlines have signed) which would prohibit advance notice of fare increases. To quote from Congressmen Oberstar and Clinger again,

"Had the comments on the value of the advance notice to consumers been filed by airlines, we would be skeptical of them. However, travel agents are fiercely independent of airlines and there is no reason why travel agents would be influenced by the airlines to claim that advance notice was of value to consumers if the agents did not honestly believe this was the case."

On behalf of Continental's customers and those travel agents who book their customers aboard our airline (and try to save money for their clients through use of first and last ticket sales dates), I hope you and your colleagues will urge Attorney General Janet Reno to set aside this case.

On a completely different topic, just last week, I served on a panel organized by the National Commission to Ensure a Strong Competitive Airline Industry with the other Chief Executive Officers of the U.S. airlines to discuss the state of the U.S. airline industry. Topics of discussion ranged from airline taxes (too high) to airline profitability (too low) to government regulations (too many).

Today, Mr. Chairman, you and your colleagues are looking at some of the same issues which are under study by the National Airline Commission. And I want to say to you what I said to them: one root cause of the industry's current dismal plight is that there are too few passengers chasing too many seats. Clearly, excess capacity in the industry contributes to our inability to become profitable.

With Continental's recent announcement that we will be purchasing some 90 new aircraft from the Boeing Company, you may wonder if I am talking out of both sides of my mouth. In fact, these new aircraft are replacement aircraft that will enable Continental Airlines to meet the government's 100% Stage 3

mandate by the year 2000. For your information, I have attached several charts to this testimony which demonstrate the origin of today's excess capacity in the domestic airline industry.

These charts clearly show that the excess capacity was not so much caused by the obstinate failure of the bankruptcy carriers to go away, but by the enormous expansion of the so-called Big Three carriers, particularly American. When the resulting industry overcapacity, although affecting industry profits, failed to shut down the weaker carriers, American decided to take more drastic action: it's so-called Value Pricing, ie.: predatory pricing scheme.

The result was that 1992, which was in the first quarter shaping up as a reasonable year, turned out to be the worst year in the history of the airline industry. One last point: if anyone were to question whether there was a dangerous probability that value pricing could have created a monopoly... the answer is an unequivocal, "Yes." With Continental and perhaps a few other carriers out of business, the airline industry would have been drastically different. The end result would have been significantly higher ticket prices - one of the touchstones of a monopoly.

As you know, one of the fall-outs of that episode is a predatory pricing lawsuit by Continental and Northwest against American that is scheduled to go to trial in a few weeks.

Finally, a few words about how airplanes now go from place to place, and how they should do that in the very near future.

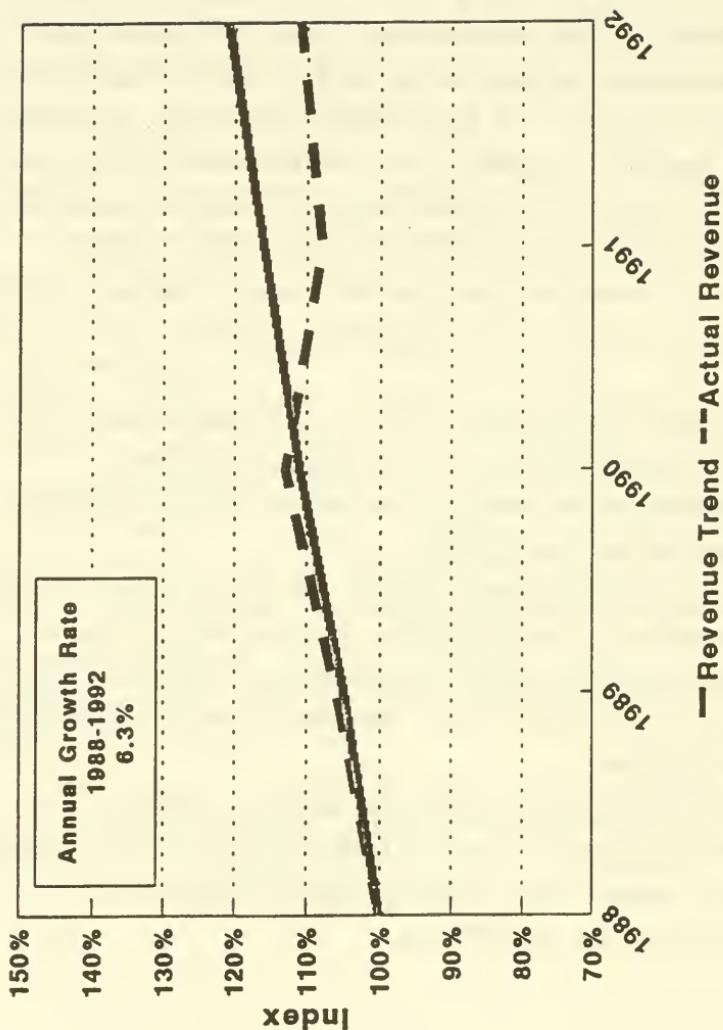
We have been waiting for what seems like an eternity for the Federal Aviation Administration (FAA) to develop a thing called Microwave Landing Systems, or MLS; and simultaneously watching millions of tax dollars being consumed by the process. In the meantime, we already have a constellation of satellites placed in space by the Defense Department which, by the use of inexpensive and readily available equipment, will enable aircraft to travel and land literally within a few feet of their destination. It is called the Global Positioning System, or GPS.

There is some study going on. We at Continental are currently participating in a test, together with the manufacturer and the FAA. But the process is agonizingly slow and needs to move more rapidly.

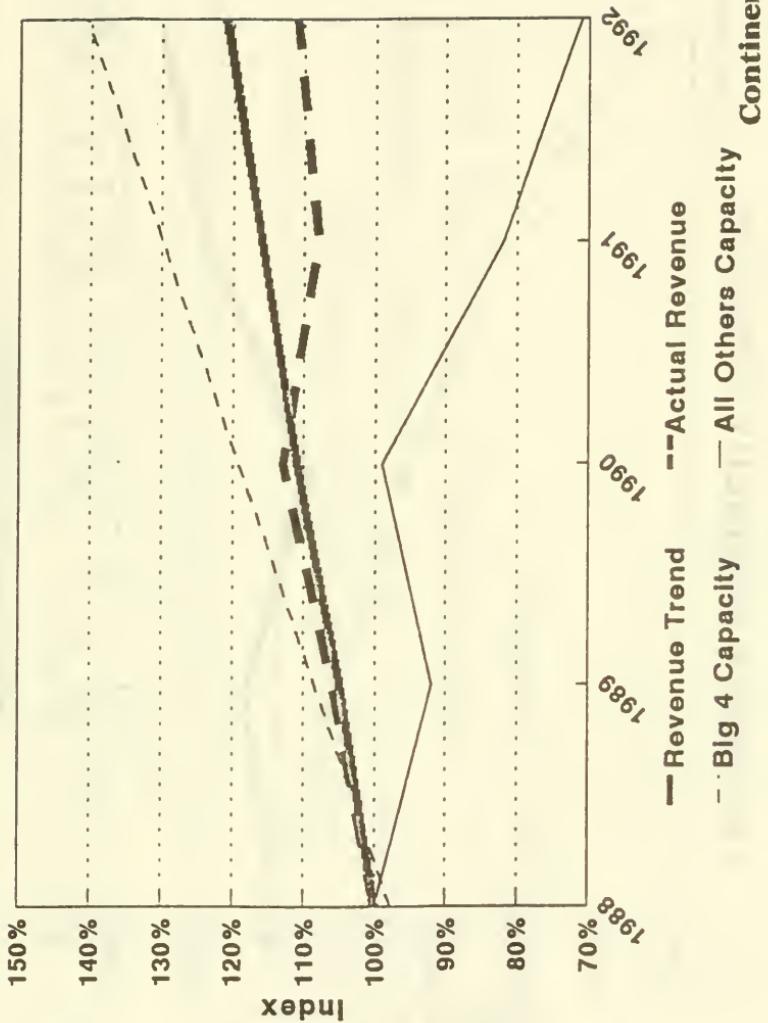
The potential cost savings to the airline industry alone are staggering. I would urge that Congress and the Airline Commission regard the speedy implementation of GPS as a means of providing financial relief and therefore competitive improvement for the industry.

I am sure you and your colleagues have questions about competition in the U.S. airline industry which I will be happy to try to answer. Again, thank you for this opportunity to testify before the Subcommittee.

## Domestic Industry

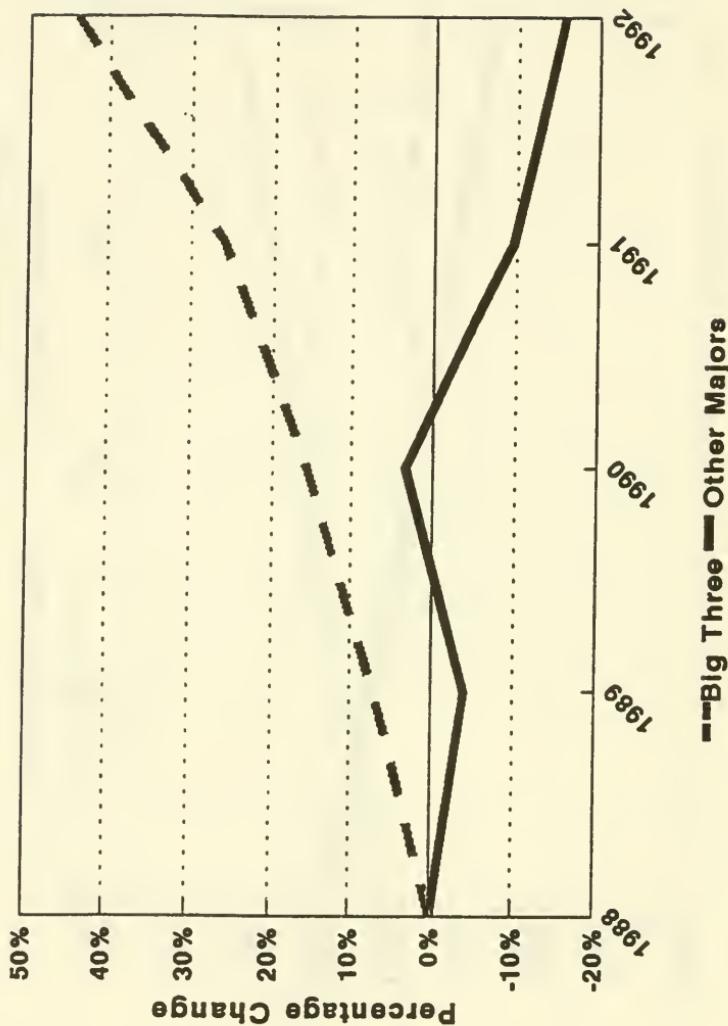


## Domestic Industry





## Industry Capacity Growth



The Atlanta Journal  
THE ATLANTA CONSTITUTION

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Sunday, January 24, 1993

\$1.75

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"The top three added enough capacity last year to create another TWA..., with enough left over for another Alaska."

Continental 

Mr. BROOKS. Our next witness is Arthur M. Luby, the general counsel for Transport Workers Union of America, AFL-CIO.

We are delighted to see you.

**STATEMENT OF ARTHUR M. LUBY, GENERAL COUNSEL,  
TRANSPORT WORKERS UNION OF AMERICA, ALSO  
REPRESENTING THE AFL-CIO AIRLINE COORDINATING  
COMMITTEE**

Mr. LUBY. Thank you, sir.

The Transport Workers Union of America, AFL-CIO, represents some 45,000 workers in the airline and aerospace industry. We represent mechanics, dispatchers, fleet personnel, flight attendants, as well as other classes and crafts.

As you mentioned, Mr. Chairman, we have significant representation on American Airlines and its affiliated carriers, but we also have representations on Southwest, Northwest, Continental, USAir, and several other carriers.

I am appearing on behalf of John J. Kerrigan, the Secretary Treasurer of the TWU, and the Director of its Air Transport Division, and on behalf of the AFL-CIO Airline Coordinating Committee.

In 1979, TWU's three largest representations were on American, Pan Am, and Eastern. Our groups on these carriers were approximately equal in size. After 15 years of deregulation, Pan Am and Eastern are, of course, liquidated. Most of the former employees of these carriers have not found work in the industry, and a substantial portion have either lost or exhausted health or welfare coverage, a problem I deal with on an almost everyday basis.

By contrast, American was, up until recently, viewed as one of the major success stories of airline deregulation. Last year AMR suffered close to a billion dollars in losses—losses which unfortunately were right in line with virtually every other major carrier in the industry, except Southwest. This has resulted in major layoffs at all carriers including American, and according to press reports we can expect much more of the same in the near term.

Our point is that after a decade and a half of deregulation, the industry is in danger of a decline comparable to that suffered by basic steel in the early 1980's.

In reviewing how we came to this state of affairs and in light of the issues you wanted to approach this morning, it is clear that the bankruptcy laws have not worked in the benefit of the industry or its employees. In particular, in dealings with bankruptcies, the TWU, as well as a number of other unions, have often observed the debtor receive continuing extensions from the court on the deadline for filing a reorganization plan while the enterprises' remaining assets were squandered by the very same managements whose errors caused the business failure in the first place.

Unfortunately, the end result always seems to be that the assets which can be used to pay employee wages or fund crucial benefits such as retiree welfare are lost in the course of the failed reorganization, normally to bankruptcy professionals and court costs.

I would add that the costs of failure to pay retiree welfare is really borne by society at large. That is a very significant cost.

In 1984, the AFL-CIO, responding in part to the Continental bankruptcy, successfully pursued amendment of the bankruptcy code to prohibit unilateral abrogation of collective bargaining agreements and require that any relief demanded from employees be truly necessary to a successful reorganization.

In the intervening years and notwithstanding these amendments, too many courts have modified agreements simply because they believed it would facilitate reorganization. Many courts have imposed such concessions without a hard look on whether the company was viable even if given such relief.

In our view, it is not a proper function of a bankruptcy court to subsidize an enterprise by granting it below-market labor costs or sacrificing employee benefits. I would hope the committee would look at this pattern of decisionmaking.

I would add that given the precarious nature of this industry and the destructive overall impact of previous airline bankruptcies, we don't need to give people with established records of bankrupting carriers yet more chances to make the same contribution to the industry and its workers.

Accordingly, we strongly support legislative efforts to prohibit individuals who have taken more than one carrier to bankruptcy from obtaining another operating certificate. That is, of course, the position of the AFL-CIO.

Now, looking at the broader issues relating to competition, in my statement I have summarized some of our concerns about the Department of Transportation's failure to realize or to realize the global impact of its decisions and the competitive disadvantage it often places on U.S. carriers.

I would add that I can't remember a time when the FAA lost more credibility with the U.S. maintenance work force than when it opened the opportunity to repair U.S. fleets to foreign repair facilities and then exempted those very same facilities from U.S. drug and alcohol testing regulations. We were told on the one hand we had to meet global competition and then had enormous cost disadvantages imposed on us virtually at the same time. That kind of policymaking which occurred in 1989 simply cannot continue if this industry is going to survive.

This completes my prepared testimony. I will be happy to answer any questions.

[The prepared statement of Mr. Luby follows:]

## Air Transport Division



TRANSPORT WORKERS UNION OF AMERICA

AMERICA'S OLDEST UNION - COMPOSER OF INDUSTRIAL ORGANIZATIONS

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CHARLES FAULDING  
International Secretary-Treasurer  
JOHN J. KERRIGAN  
Director, Air Transport Division  
AFL Vice President

BEFORE THE ECONOMIC AND COMMERCIAL LAW  
SUBCOMMITTEE OF THE COMMITTEE ON THE JUDICIARY  
U.S. HOUSE OF REPRESENTATIVES  
JUNE 9, 1993

### THE FINANCIAL CONDITION OF THE AIRLINE INDUSTRY

TESTIMONY OF ARTHUR M. LUBY  
GENERAL COUNSEL TRANSPORT WORKERS UNION OF AMERICA,  
AFL-CIO

The Transport Workers Union of America, AFL-CIO, represents some 45,000 workers in the airline and aerospace industry. TWU represents mechanics, dispatchers, fleet personnel, flight attendants, as well as other classes and crafts in the industry. We have representations on American and affiliated carriers, Southwest, Northwest, Continental, USAir and a number of other carriers. I am appearing today on behalf of John J. Kerrigan, the Secretary-Treasurer of the TWU and the Director of its Air Transport Division, and on behalf of the AFL-CIO Airline Coordinating Committee.

In 1979, at the dawn of implementation of airline deregulation, TWU's three largest representations in the industry were on American, Pan Am, and Eastern. Our groups on these carriers were approximately equal in size. After fifteen years of deregulation, Pan Am and Eastern are, of course, liquidated. Most of the former employees of these carriers have not found work in the industry, and a substantial portion have either lost or exhausted health and welfare coverage.

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By contrast, American was, up until recently, viewed as one of the major success stories of airline deregulation. However, last year AMR suffered close to a billion dollars in losses -- losses which, unfortunately, were right in line with virtually every other major carrier in the industry, save Southwest. This has resulted in major lay-offs at all carriers including American and, according to press reports, we can expect more of the same in the near term. The point is that after a decade and a half of deregulation, the industry is in danger of a decline comparable to that suffered by basic steel at the beginning of the last decade.

In reviewing how we came to this state of affairs, and in light of this Committee's jurisdiction, it is clear that the bankruptcy law have not worked to the benefit of the industry or its employees. In particular, in dealing with bankruptcies the TWU, as well as a number of other unions, have often observed the debtor receive continuing extensions from the court on the deadline for filing a reorganization plan while the enterprises' remaining assets were squandered by the very same managements whose errors caused the business failure in the first place. Unfortunately, the end result always seems to be that assets which could be used to pay employee wages or fund crucial benefits such as retiree welfare are lost in the course of a failed reorganization -- normally to bankruptcy professionals.

In 1984, the AFL-CIO responding in part to the Continental bankruptcy, successfully pursued amendment of the Bankruptcy Code to prohibit unilateral abrogation of collective bargaining agreements and to require that any relief demanded from employees

be truly necessary to a successful reorganization. In the intervening years, and notwithstanding these amendments, too many courts have modified agreements simply because they believed it would facilitate reorganization. Similarly, many courts have imposed such concessions without a hard look at whether the company was viable even if given such relief. In our view, it is not a proper function of a Bankruptcy Court to subsidize an enterprise by granting it below market labor costs or sacrificing employee benefits. This Committee should carefully examine the development of the law on this issue with an eye towards ending this sort of abuse.

I would add that, given the precarious condition of the industry and the destructive overall impact of previous airline bankruptcies, we simply don't need to give people with established records of bankrupting carriers yet more chances to make the same contribution to the industry and its workers. Accordingly, we strongly support legislative efforts to prohibit individuals who have taken more than one carrier into bankruptcy from obtaining another operating certificate.

Looking at broader issues relating to competition, the TWU has long-term concerns about the capacity of the remaining U.S. carriers to deal with foreign competition. U.S. carriers must now compete on international routes with foreign operations that are often directly subsidized by their governments or are at least the beneficiaries of government sponsored welfare programs which substantially lessen the cost of providing employee benefits.

Unfortunately, the Department of Transportation has yet to

develop a coherent regulatory approach to this reality. For example, over the past few years, the FAA has imposed expensive new safety requirements -- such as ground de-icing and drug and alcohol testing -- and then substantially exempted foreign carriers operating in this country from compliance. The FAA has generally justified this approach by claiming that the cost of compliance is offset by the flying public's enhanced confidence in the safety of U.S. carriers. Yet, I am dubious about how many passengers choose American 'or United over British Airways for flights into Europe because of the greater assurance of safety purportedly brought about by U.S. drug and alcohol testing policies. In short, we have reached the stage where the Department of Transportation and Congress can no longer impose major new regulatory costs on U.S. carriers and workers without accounting for whether such requirements will be adopted world wide.

This completes my prepared testimony. I will be happy any questions.

Mr. BROOKS. Thank you very much, gentlemen. Mr. Crandall, how do investments by foreign carriers in domestic carriers affect the ability to compete domestically and internationally?

Mr. CRANDALL. Mr. Chairman, the answer to your question lies not so much in the investments by foreign carriers, but in the operating rights and privileges granted to those foreign carriers. Let me use as an example the recent, highly publicized investment by British Airways in USAir.

The investment by British Airways in USAir, by itself, has no effect on us. The problem is that the U.S. Government has granted British Airways the right to do something we call code-sharing with USAir, so that, in effect, a USAir flight from any point in the United States to any gateway city in the United States connecting with a British Airways flight across the Atlantic may now be labeled British Airways.

Thus, British Airways is now able to serve some 20,000 worldwide markets that American Airlines is not able to serve. For example, a passenger in the United States who wants to go from San Diego, CA, to Cairo, Egypt, can now fly all the way from San Diego to Cairo on "British Airways." In fact, transportation within the United States from San Diego to a gateway will be on USAir, but that flight will be labeled, for consumer purposes, as a BA flight.

Since American cannot serve London to Cairo, Egypt, American cannot take that passenger from San Diego to Cairo. Passengers, by a margin of more than four to one, prefer to travel entirely on the same airline from where they start to where they finish. Therefore, the U.S. Government's policy of allowing foreign airlines to draw traffic from within the U.S. markets to link with worldwide networks is gradually placing U.S. carriers at a terrible, competitive disadvantage.

Today, British Airways has the unrestricted right to code-share with USAir across the United States. KLM has the unrestricted right to code-share with Northwest across the United States. But in those restricted markets on the other side of the European gateways, American Airlines is not permitted to compete.

In effect, we are creating a circumstance where the only truly worldwide airline networks will be owned and controlled by foreign airlines, since there are no foreign airlines that we can buy or control.

That practice, in my judgment, is the practical equivalent of taking another worldwide industry and turning its control over to non-U.S. interests.

Mr. BROOKS. I think you ought to bring that to the attention of Mr. Kantor, the U.S. negotiator.

Mr. CRANDALL. I have done so, sir; and I hope for your support.

Mr. BROOKS. I think you will have my full support in that effort. I think it is a bad idea. I believe in fair trade, equal trade, equal opportunities for our business as well as theirs.

Now, you have been quoted as testifying that if we want a competitive system, we must allow the market to finish the painful process of eliminating whatever number of carriers are surplus to the market's needs. This is out of the National Journal in 1992. At the present time, do you believe there are any surplus air carriers as of now, in other words in 1992, a year later?

Mr. CRANDALL. I don't know, Mr. Chairman. The point I was making there, and the point I have tried to make in my testimony this morning is that the number of air carriers that will exist in a competitive airline system is something that I am not wise enough to forecast.

But I think we must let the market make that choice. And the point is, we have not let the market make the choice because we have created bankruptcy laws that effectively prohibit failure.

Mr. BROOKS. Mr. Ferguson, Mr. Crandall testified that prolonged bankruptcy proceedings can unfairly benefit insolvent air carriers, allow them to undercut their competitors' prices. To what extent is this consistent with Continental's experience in bankruptcy? You have got probably more experience than most in that field.

Mr. FERGUSON. Unfortunately, that is true, Mr. Chairman.

Mr. BROOKS. The experience—

Mr. FERGUSON. The experience. With respect to bankrupt carriers and fare cutting—I guess I would like to back up to a quick comment that Mr. Crandall made about bankruptcy laws not permitting air carriers to fail, meaning fail absolutely, ground their equipment.

I believe the same study he cited earlier with respect to the virus invading the industry; i.e., bankruptcy, would prove that of the 117 air carriers that have filed for bankruptcy in the 12 to 14 years since 1978, all but one completely and abjectly failed. They were unable to reorganize.

With respect to his statistics that he cites with regard to carriers' underpricing, it is certainly true that weaker carriers have from time to time taken the opportunity to use their cost structures to offer lower fares. On the other hand, Southwest Airlines routinely offers lower fares, having never been bankrupt and having been very successful in doing so and having a cost structure which in order of magnitude is better than Mr. Crandall or any of the prederegulation airlines' cost structures.

Finally, with respect to discounting of airfares, in all of 1992, the statistics that Mr. Crandall cites are, quite probably, approximately correct. What they fail to recognize is that there were only two fare cuts of any significance in 1992, the first of which occurred on April 9th, the second of which occurred on May 27th; and together they were singularly responsible, in our opinion, for the vast majority of the industry's losses in 1992.

Those fare cuts were not initiated by any bankrupt carrier or any financially troubled air carrier. They were, in fact, initiated by American Airlines.

Mr. BROOKS. Mr. Luby, how do labor costs affect the competitiveness of new startup carriers?

Mr. LUBY. I am only really prepared or knowledgeable about one of the what you would call "new carriers," and that is not new, which is Southwest Airlines. I know of other new carriers which obviously have lower labor costs primarily because their employees have not yet engaged in collective bargaining. But Southwest is the most heavily unionized carrier right now, and it has a number of cost advantages. One of them is labor cost; but part of the advantages relate to getting very high productivity out of its employees,

and I think that is a direct reflection of the level of commitment they have been able to obtain from them.

And I know in the case of flight attendants, the take-home pay of flight attendants compares very favorably with anyone else in the industry. Where in my own analysis and the union's analysis they have tended to save some money is in long-term benefits, like retiree welfare and avoiding a defined benefit pension plan; and of course, as I think was the reference in Mr. Crandall's statement, there are some long-term problems with that approach, too. But on the other hand, I would have to say that it is a carrier that has enjoyed very good relations with its unions, while at the same time inspiring a pretty high degree of commitment and productivity.

Mr. BROOKS. Mr. Fish. Do you have a few questions?

Mr. FISH. Thank you, yes, Mr. Chairman.

Mr. BROOKS. All right. The gentleman is recognized.

Mr. FISH. To follow up on the chairman's line of questioning, this question goes to both Mr. Crandall and Mr. Ferguson.

Let's envisage a domestic marketplace in which bankruptcies and mergers have reduced the number of major carriers to just three. What would be the state of competition in such an environment? Might there not be an irresistible tendency among the survivors to divide and allocate markets in order to maximize profits?

Would the gentlemen care to comment on that?

Mr. CRANDALL. Mr. Fish, I would be happy to comment.

The answer to your question, of course, is that nobody knows. The chairman has made the point that the airline industry on a cumulative basis, since the Wright brothers first flew, has lost about \$4 billion. So we have lost more money in the last 3 years than we made in all the years between Kitty Hawk and 1990.

Air carriers compete in what we call origin and destination markets. In most of those markets, no airplane flies from the point of origin to the point of destination. San Diego-Albany might be an example. There are many ways to go from San Diego to Albany by way of one of many hubs that operate in the United States. A consumer who wants to go from San Diego to Albany has many carriers to choose from. If there were only three carriers in the United States—and I frankly doubt the number would ever be that small, even in a purely competitive system—I suspect that every one of those three carriers would serve virtually every origin and destination market in the United States. So long as that were the case, I think competition would continue to be intense.

I think one of the very interesting phenomena is that as the number of carriers has decreased, the average number of competitors in each origin and destination market has increased. So the two numbers have moved inversely.

The reality is that the airline business is a network business. The presence of half a dozen, 10, 12, 15, 25, or 100 regional carriers would not affect competition in most of the origin and destination markets around the United States to much of an extent.

In any case, we have a joke in the industry that says that things are so bad in our industry, if the Wright brothers were still around, one would have to lay the other off. Before we worry about excessive profitability and abuse, I think it would be useful to allow the industry to return to at least reasonable profitability.

Mr. FISH. Mr. Ferguson.

Mr. FERGUSON. Our primary view would differ from Mr. Crandall's, although we would acknowledge many of the statistics that he cites. Our belief is that if three air carriers were the remainder of what once was a vibrant industry, that they, in concert, whether acting overtly or not, would be able to effectively control prices in the industry and would be able to exercise the equivalent of a monopoly of power.

The classic oligopolies that existed in the early part of this century were examples where those kinds of situations happened, and we believe that would be repeated once again if we were to reduce the industry to that level of competition.

Mr. FISH. Thank you. Mr. Crandall, I understand that American Airlines has increased its passenger capacity 37 percent since 1988. Now, it has been said that the assumption behind this was that American would emerge as a winner and fill the seats because bankruptcy would eliminate weaker carriers.

In fact, increased marketplace share has not occurred; American is losing money because passenger mileage is relatively flat and the bankruptcy courts have kept bankrupt carriers alive. Do you have a comment on this analysis?

Mr. CRANDALL. Yes. I really don't know who writes such errant nonsense.

Congressman Fish, the Congress created in 1978 a competitive airline industry, and asked that the airlines go and compete. In 1980, American Airlines had the highest cost per available seat-mile of any carrier in the airline industry; we set out to lower our costs. The only way to lower our costs was to fly more airplanes at more attractive rates.

So in 1980 we realized that the only way to compete with the new entrant carriers was to create a new airline within the existing airline, and that is exactly what we did. We invested about \$15 billion; we essentially doubled the size of the airline. We created 60,000 jobs, and we lowered our cost per available seat-mile by 22 percent.

Nothing that we ever did presumed any action by any of our competitors; whether they would stay in business or go out of business was a complete irrelevancy. The objective of growth on the part of American Airlines was to reduce the cost of producing air product and become more productive.

We have done so. Over the years between 1978 and 1993, American has become a relatively much more successful carrier than it was in 1978.

The people who say that buying new airplanes, becoming more efficient, and growing larger are somehow antithetical to the notion of a competitive industry don't understand how competition works.

Mr. FISH. Thank you.

Mr. Luby, do you have any comment on that question?

Mr. LUBY. Well, other than I agree it is errant nonsense, to the extent that I have analyzed it from our perspective, I think most carriers have become more productive and American certainly has, too. One of those—one of the reasons I think it has become more productive is, if you look at the ratio, for example, in maintenance, of bargaining employees to supervisor, American has cleaned out a

lot of bureaucracy and a lot of supervision; and its work force, by doing that, is much more productive. There are also incentive clauses in American.

So some of the things that were referred to earlier in response to Chairman Brooks about inducing high productivity through intelligent bargaining, those have occurred at American, too, and I am sure they have occurred in other carriers that other unions are involved in.

Mr. FISH. We have heard competition come up a few times. Mr. Crandall, as you know, the Department of Transportation recently challenged Northwest Airlines' plan to start flying three routes in competition with Reno Air, a new carrier, after Reno complained that Northwest was seeking the routes in order to destroy Reno through anticompetitive, predatory action.

And so my question to you—I know this doesn't concern your airline, but the philosophy does—where should the line be drawn between protecting new entrants and allowing full play to competitive market forces?

Mr. CRANDALL. Congressman Fish, I think if we want to have a competitive industry, we are going to have to let people compete. Consumers have very little loyalty. Consumers choose an airline on the basis, fundamentally, of two factors: price and schedule. Schedule is fundamentally where you go and how often you go there.

If a carrier, Northwest or any other, is not permitted to compete with a new entrant carrier on any particular route and is not permitted to match that new entrant's price, whatever it may be, then that carrier is going to have to watch the business flow to the new entrant carrier.

So I think the whole notion of trying to, quote, "protect," end quote, new entrant carriers has to come down to some kind of prohibition on competition with those carriers by the existing carrier.

There is another new entrant, for example, in Newark, NJ, by the name of Kiwi, that recently complained about the fact that Continental was engaged in some sort of predatory competition. So far as I know, Continental did not do anything but match Kiwi's prices and match Kiwi's schedules.

So I think you have a very difficult situation here. The fact is the airline business is intensely competitive. Products are chosen based on price and schedule, and a carrier which is not permitted to match price and schedule is going to be vanquished by any new entrant that chooses to offer a particular schedule at a price which the existing carrier is not permitted to match.

So, frankly, just how we might go about quote "protecting," unquote, new entrant carriers, baffles me a bit.

Mr. FISH. Thank you.

Mr. BROOKS. The gentlewoman from Colorado, Mrs. Schroeder.

Mrs. SCHROEDER. Thank you, Mr. Chairman. I would like to thank the witnesses.

I would like to look at this from my Armed Services background, where I chair Military Research, Development and Conversion, and our tremendous concern about retaining the tech base in America as we downsize some of our very critical industries. We don't seem to have anything in the civilian sector to transfer them to.

Now, obviously, high performance aircraft is one of those areas that we are very troubled by.

Let me ask you first, Mr. Crandall, I was very disappointed to read that American Airlines is buying Airbus at the same time that Boeing is laying off 26,000 people. We are trying to figure out what to do with these other aircraft workers.

Could you tell us why? Is it because it is more efficient, or did you get better credit on the deal? Because we want to retain American carriers; but we also need to retain this important technical base, and we seem to be—

Mr. CRANDALL. I share those concerns, of course. Let me first make the point that American is the largest airline in the world. We operate approximately 625 airplanes, and 35 of those airplanes are manufactured by Airbus. So the vast majority of our airplanes are manufactured either by Boeing or by McDonnell Douglas.

The 35 Airbus airplanes that we happen to operate are a model that competes directly with the 767, which is manufactured by Boeing. You will find that airlines, particularly very large ones, try to buy fleets of aircraft whose performance capabilities match the routes that are going to be flown.

There was a competition of American between the 767 and the 8300's. We selected the 767, the Boeing product, as our basic international airplane. We have a much larger fleet of those than we do of the Airbus machines.

Those 35 Airbuses are flown into the Caribbean, but we have relatively short-stage lengths and a need for a high proportion of belly space, cargo space relative to passengers. The Caribbean market has two characteristics. In the first instance, there is a substantial importation of bulk products. Secondly, the people who go to the Caribbean carry a higher number of bags per passenger than do typical passengers. I guess because they are going down there to have a good time.

In any event, the Airbus airplanes were uniquely suited for that particular mission, and that is why we bought the limited number of 8300's. But as I have mentioned already, the vast bulk of our fleet is U.S.-manufactured.

Mrs. SCHROEDER. Was there a better financing package?

Mr. CRANDALL. No. As a matter of fact, when we were buying airplanes the group of 767's for our transatlantic routes and the 8300's for the Caribbean routes, the price and financing choices between the two airplanes were virtually indistinguishable.

Mrs. SCHROEDER. Mr. Ferguson, your comments about the global positioning system interested me a lot. I assume, Mr. Crandall, you would agree with that; or would you disagree?

Mr. CRANDALL. Yes, I agree fully with what Mr. Ferguson had to say both about that system and about the rate at which we should progress with the improvements in the air traffic control system. There is great progress that could be made there.

We would very much like to urge the FAA to accelerate its efforts in this regard.

Mrs. SCHROEDER. And you are experimenting now, as I understand, with them on this?

Mr. FERGUSON. Yes. In fact, we are equipping a limited number of aircraft with GPS equipment at this very time, most of which will, in fact, be operated in your State, Colorado.

A short while ago, I might add, we installed the necessary equipment at Houston Intercontinental Airport to make it capable of category 3 operation with the Global Positioning System. It occurred one morning and took about a half-hour. We carried a \$17,000 transmitter to the roof of a building and plugged it in with an extension cord.

Mrs. SCHROEDER. So it really is off the shelf; you are not making this up?

Mr. FERGUSON. No, this is technology that is readily available; it is available today, and it will literally save hundreds of millions if not billions of dollars a year.

Mrs. SCHROEDER. That is very interesting.

I just wanted, also for the record, Mr. Chairman, to ask the two carriers how much charter service they did during the Gulf War for the Defense Department, because I think——

Mr. BROOKS. For the record?

Mrs. SCHROEDER. If you could, that would be helpful, because that is important vis-a-vis looking at what would happen if we had foreign carriers operating here, whether they would be willing to participate.

[The information follows:]

SUBMISSION FOR THE RECORD BY AMERICAN AIRLINES  
RELATED TO THE HEARING OF THE SUBCOMMITTEE ON ECONOMIC  
AND COMMERCIAL LAW CONCERNING THE AIRLINE INDUSTRY

On May 20, 1993, Subcommittee on Economic and Commercial Law held an oversight hearing to consider the state of competition in the airline industry. During the hearing, Representative Schroeder (D-CO), asked the carriers present to supply for the record information about the extent of service that they provided during the Persian Gulf Crisis. The submission of American Airlines is provided below.

Civilian aviation -- through the Civil Reserve Air Fleet -- ("CRAF") contributed significantly to the defense readiness of the United States during the Persian Gulf Crisis. The scope of the logistics operation was massive. We understand that during the course of the crisis, the United States deployed thousands of personnel and airlifted thousands of tons of equipment. CRAF aircraft conducted a significant number of the total missions of the operation. American Airlines conducted 98 round trip operations, providing flight crews and aircraft (McDonnell-Douglas DC-10s and Boeing 767s) to meet the mission needs of the Defense Department.

The context of Representative Schroeder's inquiry indicates her concerns about how a change in foreign investment policy could affect CRAF and ultimately defense readiness. Carriers that are even partially owned by foreign entities may be less inclined to assist in resolving international conflicts and participate in CRAF operations. If this were to happen, the U.S. carriers that chose to participate in CRAF would have to assume the added burden of the non-participating carriers. This result could create a competitive disadvantage for the carriers participating in CRAF. Finally, concerns have been raised about whether the assets of U.S. carriers could be used directly or indirectly by foreign carriers to satisfy the defense-related obligations of another nation.

The appropriate committees in Congress should examine the extent to which a change in foreign investment policy could affect the ability of civilian aviation to respond to the changing needs of the Department of Defense.

## Continental



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June 30, 1993

The Honorable Jack Brooks  
Chairman  
House Judiciary Committee  
B-353 Rayburn House Office Building  
Washington, D.C. 20515

Dear Chairman Brooks:

During the June 9 hearing of the Economic and Commercial Law Subcommittee on Competition in the Airline Industry, Congresswoman Pat Schroeder asked about Continental Airlines' participation in the Civil Reserve Air Fleet (CRAF) program during the 1990 Desert Shield/Desert Storm military operations. For the official hearing record, I am proud to report that Continental flew 85 missions. Furthermore, at the time when military CRAF requirements were at their greatest, Continental was using three widebody aircraft and running multiple daily missions.

If you need any additional information with regard to this issue, please feel free to contact me or Continental's Washington, D.C. office (Nancy Van Duyne; 202/289-6060). Thank you for the opportunity to appear before your subcommittee.

Sincerely,

Robert R. Ferguson, III

Mrs. SCHROEDER. Thank you very much.

Mr. BROOKS. Mr. Gallegly.

Mr. GALLEGLY. Thank you very much, Mr. Chairman.

Mr. BROOKS. The gentleman from California.

Mr. GALLEGLY. Thank you, Mr. Chairman.

Underfunded pension plans result in substantial losses sustained by the Pension Benefit Guaranty Corporation in bankruptcy cases. Do either of you have any suggestions for ameliorating the problems associated with underfunded pension plans? Mr. Crandall, then Mr. Ferguson.

Mr. CRANDALL. Yes, I think Congress passed legislation some years ago, as you know, called the ERISA legislation, which essentially requires that defined benefit pension plans be adequately funded.

Unhappily, the administration of that legislation has been, in my view, inappropriate, and as carriers have experienced losses and financial weakness, they have received waivers. The waivers should stop. A carrier that cannot make its pension contribution should be required to liquidate.

We simply have to stop giving people waivers every time they get in trouble, and shifting the burden both to the healthy carriers and to the taxpayers.

Our pension plan is fully funded. Nonetheless, we pay premiums of several million dollars a year to the Pension Benefit Guaranty Corporation for no purpose other than to provide funding for the underfunded plans of airlines who have not put the money away.

It is simply, in my view, a gross abuse of the process.

Mr. GALLEGLY. Thank you.

Mr. Ferguson, do you have a different perspective on this?

Mr. FERGUSON. Actually, in some respects I agree with Mr. Crandall. There are proper times to grant waivers of contribution requirements and there are probably improper times. It is probably fair to say that more waivers have been granted by the U.S. Government than would be appropriate, the IRS in particular.

But the real problem with underfunded pension plans, in my view, has little to do with waivers. The real problem and the underlying core problem is the propensity of management and labor groups to substitute massive benefit improvements for wage increases and other increases in compensation.

The typical reaction is that it is not to be paid for today. And so you have significant increases.

If you look at Eastern Airlines, which I have some passing familiarity with, you will find that the vast majority of the unfunded pension plan liability which went unsatisfied was as a result of massive benefit increases promised in the final years of its survival, and those promises were never satisfied. Notwithstanding, the company met the funding obligations as it went forward. Because you fund over such long, long periods of time, those obligations aren't present valued for purposes of looking at the real economic cost.

Mr. GALLEGLY. Thank you.

Mr. LUBY. I can add something to that, because we have labor groups on both Eastern and Pan American who—for—on working for those carriers, they received waivers for failure to meet pension

contributions. And in none of those cases did those waivers really result in long-term viability for any of those carriers.

In our reasoned view, and particularly in the case of Pan Am, and I think in the case of Eastern flight attendants, there were no massive benefit promises or enhancements in the final years leading up to the liquidation of those companies. But I believe the perception after the fact of our leadership was that the money that should have been used to fund their pensions and to fund retiree welfare was squandered in price wars.

Mr. GALLEGLY. Mr. Luby, what effect has the present pattern of heavy losses in the airline industry had on organized labor's ability to negotiate?

Mr. LUBY. Poor effect. We have not—we are not scheduled to sit down with American Airlines until 1995. I am not sure when we are scheduled to sit down next with Continental.

But I have never known a management that didn't come into bargaining that was losing money that didn't mention that right out of the block, and I am sure it will be mentioned right out of the block.

Mr. GALLEGLY. I don't mean this to be a rhetorical question, but I would like to have a real straightforward answer from both Mr. Ferguson and Mr. Crandall, and as candidly as you can. There has been a lot of discussion in recent days—and in fact we are going to be discussing that here in the other body this week—the issue of an energy tax.

What kind of effect is that going to have directly—more specifically with the current situation—on your company, Mr. Ferguson?

Mr. FERGUSON. The Btu tax will for Continental Airlines—

Mr. BROOKS. Would have.

Mr. FERGUSON. I did read the comments this morning.

Mr. GALLEGLY. As of a couple of days ago there would be no negotiating on that, but I guess there has been some change.

Mr. BROOKS. If you listened to Senator Bentsen yesterday, you know that is a dead duck, and I am delighted.

Mr. FERGUSON. We are actually relatively pleased ourselves. As originally proposed, our view is that the Btu tax could have cost Continental Airlines about \$150 million a year, just about twice what it should have cost, because of the nature of the way the tax was proposed to be imposed, that is to say, on the input Btu's going into the refinery, and not on the output.

If the tax had been imposed upon the output, the cost to Continental Airlines would have been about \$70 million per year at the end of the day. We are 10 percent of the industry, a little bit less. That is 7 or 800 million for the industry in total.

We can argue about the elasticity of passenger demand. We would have obviously tried to pass it on to the passenger in terms of higher fares. We either would have been successful in that or we as a company would have had to eat the \$70 million. The best example of that is the ticket tax increase of 2 percent that went into effect in December of 1990, a period of weak traffic, weak fares.

The airlines had to eat that increase, that 2 percent increase. The Btu tax, if we continue to have the current environment, would have been simply a tax on the airlines.

Mr. GALLEGLY. Thank you very much, Mr. Ferguson.

Can I just ask Mr. Crandall to very quickly respond for the record?

Mr. CRANDALL. I wouldn't quarrel with that. For us, a penny a gallon is \$30 million a year.

Our rough, back-of-the-envelope calculations suggest that the Btu tax as proposed would have cost something on the order of 10 to 12 cents a gallon. It would have had a dramatically adverse impact on travel because we would have had no choice but to increase prices to reflect it. We think it would have been very damaging both to the airline industry and to the economy in general.

Mr. GALLEGLY. Thank you very much, Mr. Crandall.

Thank you, Mr. Chairman.

Mr. BROOKS. You can almost write that script for them. I do want to point out that we have with us this morning one of the most distinguished, the most recognized, and the most able State senators in the State of Texas, Mr. Carl Parker, my friend and senator. His associate, Senator Dan Shelley, who represents a small part of my district and who is learning to be the same kind of dedicated public servant, is also with us. You will all be happy to know they came up to work against the Btu tax, primarily.

Mr. FERGUSON. We appreciate that.

Mr. CRANDALL. That is good.

Mr. BROOKS. We have seven refineries in my congressional district, and it did seem to impact rather heavily on them. Fifty-nine cents per million Btu's vis-a-vis 26 cents for coal and gas. I thought that was a tiny bit discriminatory.

Mr. CRANDALL. Sounds that way.

Mr. BROOKS. I think we have a can tied to its tail on that one, where it ought to be.

Mr. Berman.

Mr. Glickman, the gentleman from Kansas, who is an expert on many aspects of aviation since he is from Kansas where a lot of hubs are located.

Mr. GLICKMAN. It is where we used to make planes, Mr. Chairman, unfortunately.

Thank you for calling this hearing. I think it is a very important hearing. I just want to make a couple of quick comments.

With all the flak the aviation industry gets, I want to say that for the most part those of us who are frequent flyers have to acknowledge that we have the best, safest aviation system in the world. When you consider that we have about 15,000 flights a day in this country, and the safety record is impeccable, and the food isn't so hot, but the service is pretty good, and for the most part it has brought the country together. What is not taken into this equation is even with deregulation, I realize the aviation industry, the airline industry, has been hurt in some respects, and I don't like that. Other parts of America have been made much more productive because of airline deregulation, because people now use the airplanes the way they used to use the bus. It is a primary motive, nonautomobile travel in America, and to a large extent that has happened since 1978. So I don't think it is all terrible.

That we can't get stable, profitable carriers is terrible. I would like to see us work on that. But we tend to demean the industry too much.

I know Mr. Crandall, I don't know the other gentlemen. He and I have been in contact many times recently. I hear the traffic in Wichita has gone up higher than ever in the month of May largely as a result of your very kind fare structure changes in the community of Wichita, which we are most appreciative of.

I still have a problem with a certain piece of legislation that former Speaker Wright dealt with which provides a protected status for one airport in America called Love Field. For those of you who don't know, there is one airport in America that, by Federal law, an airline cannot fly to any points from that airport except within that State and the four contiguous States around that State. That is called the Wright amendment. In my judgment, it is a very anticompetitive amendment.

I think Continental Airlines was involved in some litigation with this a few years back. We have talked about it before in terms of other issues. It is much more complicated than this, and my interest in this is obviously dealing with fares to my communities. But it is something I still want to work on.

I guess my concern is, the airline market is more concentrated, yet less profitable than ever. That is the irony of all this. When you look at 1978 and you look at today, there are fewer, larger carriers, yet none of you are making any money, particularly American, which is the dominant, or one of the three dominant carriers in America. Maybe others will move into that range, I don't know.

Just simply stated, why can't you make money?

Mr. CRANDALL. We cannot make money, Mr. Glickman, because of the inherently competitive characteristics of the airline industry.

I made the point before that although there are fewer carriers than there were at one time, there are more competitors on each origin and destination route than there have ever been before.

The inherent characteristics of the airline business go something like this. Once you own the airplane, you better fly it. There is nobody else to buy it, and if you put it on the ground, you have to continue to pay the rent. The incremental cost of flying one more flight is a small fraction of the average cost of flying a flight.

Secondly, the incremental cost of putting one more passenger in an otherwise empty seat is a small fraction of average cost. Thus, every carrier competing with many other carriers on a particular route has great incentive to reduce the price in the hopes that reducing the price will produce sufficient additional passengers to increase total revenues.

In fact, that competition, which has gone on now for many years, has not, over the period of airline deregulation, produced enough incremental passengers to offset the decline in yields. These are the fundamental economic principles of the airline business. This is the great experiment that is going on in America, in most other countries the airline business is heavily regulated.

The question before the House, and I think the question that only the marketplace can answer, is, can there be a healthy, competitive airline industry? I don't presume to be wise enough to know the answer.

Mr. GLICKMAN. You can't give us an answer to that?

Mr. CRANDALL. I cannot give you the answer to that.

I will say this to you. In my judgment, if we want to try to have a healthy, competitive airline business, we have to let the market work. And that, of course, is the thrust of my comments.

Mr. BROOKS. If the gentleman will yield, I want to observe that history reflects and current practices reflect that in international competition, every American airline has had a distinct disadvantage, whether you are Frank Lorenzo starting a new one flying to Jamaica or whether it is established airlines now here with hundreds of airplanes and billions of dollars invested. They are at a big disadvantage when they go to England, France, Switzerland, Spain, Swaziland, you name it. These airlines are run by the country in which they operate. Of every advantage in landing rights, in expenses, in services, in clearances, they get the first 10, and then Americans and others get the remainder. It gives them a tremendous advantage in every country in the world.

Aside from the arguments we have with our locals, we must do everything we can to help U.S. airlines compete in the world marketplace, because other countries do not treat our airlines as fairly as we treat theirs.

Now, that is a simple fact. They undercut us in more categories than I know of. You know, a list this long, where there are advantages for British Airways, for Air France, for Swiss Air, Germany, Belgium, you name them. These countries all have good airlines that they own—not in effect own, but each country protects its airline as if it were a major stockholder. It puts us at a great disadvantage, Mr. Glickman, from either buying American airplanes or making money overall.

Mr. GLICKMAN. That is true, and I agree with that. But that doesn't take away from the fundamental heart of the domestic airline industry in terms of capacity, profits, pricing problem.

It is kind of chasing your tail around in order to get three more passengers on a flight from New York to California, which is what you are saying. You drop your fares down so that you basically haven't gained any money from that proposition.

Let me ask you this question, because I am sure that some of these will be addressed in this airline competition thing. Let me take the case of Southwest Airlines, which of course has been generally a profitable carrier in recent years. And, of course, I have become more familiar with it because of the Love Field issue.

But beyond that, Southwest operates differently than Delta, American, or United. It doesn't operate with a hub and spoke system, for the most part. It operates more direct city-to-city routes, not totally.

To what do you attribute an airline like Southwest being able to make money? Is this a harbinger for your industry in the future? Both Mr. Crandall and Mr. Ferguson.

Mr. CRANDALL. The Southwest phenomenon has its roots in many different realities. Southwest, of course, started as a non-CAB regulated intrastate as opposed to an interstate carrier. It therefore was created, unlike most carriers with which it competes, to do a particular kind of thing; that is, fly very short distances. It built a service package; that is, a package of product features that allow it to produce a seat-mile for substantially lower costs than the rest of us.

For example, they have more seats on the airplane. Thus, assuming it costs the same amount to fly the airplane, their cost per seat is going to be lower. They have no galley facilities on the airplane. Thus, they can put seats where the galleys are. They have no food service on the airplane. Thus, they have fewer flight attendants per flight and per seat. They do not bother with things like advance seat assignments. So there is a whole array of product features that Southwest does not offer.

Moreover, the fact that they started that way—as Mr. Luby noted—has led the people of Southwest to have a different set of expectations than do the employees of companies that started in the 1940's and 1950's, were regulated by the CAB for many years, and produced a package of services under working conditions which were essentially standard throughout the industry.

The question is often asked, why don't the existing carriers simply make themselves into clones of Southwest? The answer is, you could not do that without doing two separate things, both of which would be quite draconian.

First, we would literally have to tear up our labor contracts and start again. The employees of American, Delta, and United are not prepared to do that, because those contracts produce work rules and a whole variety of other things, as well as compensation per hour, which is very different than what Southwest has.

Second, we would have to exorcise from our company the capability to provide kinds of services which Southwest does not provide.

It is possible for us to carry people between San Diego and Albany because we have a number of capabilities including the hub. Hubs are widely derided these days, but the fact is most of the origin destination markets in America are served by way of hubs. That is because hubs are the most cost-effective way to connect cities that do not have enough density to be served nonstop by carriers like Southwest.

So the reality is that Southwest has a different historical perspective, has employees with very different sets of expectations, and, as a consequence, has been able to be profitable. The marketplace will compel the rest of us to make whatever changes that must be made to preserve our companies.

The alternative is to go outside of business. Whether we will emerge looking like Southwest or looking like some combination of Southwest, and what we are today or something entirely different than what we are today, really requires more foresight than I have.

But the fact is the only way that we can get there is to let the marketplace beat on us until we create the changes, whatever they may be, that will allow us to operate properly.

Mr. LUBY. Can I add something to that? We have major agreements with both Continental and Southwest. Southwest writes on a blank slate and is able to develop contracts which exchange high compensation for high productivity that are different from almost any other contract in the industry, and probably would not—in fact, I am quite sure would not be accepted by most other folks for a lot of different reasons, most of which have to do with the nature of the operation.

But I recall there was a booklet put out by a fellow saying the secret of Southwest Airlines and advocating that everyone adopt

this approach. John Kerrigan, my client, knows just about everyone in the industry. This is a fellow he had known at Pan Am and a number of other disaster areas, and his eyebrows always raise when he sees the same pallbearers, because he thinks he is at the same funeral.

Southwest contracts out a lot of its maintenance. The consequences of that for American would be catastrophic, for Mr. Synar's district, and a number of districts in Texas. American is one of the leading providers of aircraft maintenance services in the United States.

Mrs. Schroeder was very concerned about having high-tech jobs. If all that work was contracted out, where would those jobs go?

So Southwest has adopted a strategy which they can use and which they have been successful at, but to say that that is adaptable to the entire industry, I think there would be major social consequences for every carrier who adopted that strategy.

Mr. BROOKS. Mr. Canady.

Mr. CANADY. Thank you, Mr. Chairman.

I would like to start by asking this question of Mr. Crandall and then I will ask Mr. Ferguson to respond.

Mr. Crandall, what is your response to the argument that some have made that substantial segments of the traveling public in fact seek to avoid traveling on carriers in bankruptcy, and that this reluctance of the traveling public effectively neutralizes the advantages that bankrupt carriers or carriers in reorganization may derive from the provisions of the Bankruptcy Code?

Mr. CRANDALL. During Eastern's bankruptcy and the day after, major headlines in the New York Times stated that the Eastern supervisors had been cited for maintenance oversights in New York. Eastern had the highest load factor in the airline industry.

Mr. CANADY. Mr. Ferguson.

Mr. FERGUSON. I have no way to comment on that at all. I would suggest, however, that if what Mr. Crandall said is true, and I suspect it is, you would find that it was completely driven by having lower fares than everybody else.

There is certainly no question but that our research would support that a significant, although considerable minority, but a significant percentage of travel agents and air travelers will avoid bankrupt carriers in the absolute.

As an example, during the course of our bankruptcy, 8 percent of the travel agents in America said that they would not book a passenger on Continental Airlines. Eight percent doesn't sound like much, but in a business where the profit margin is 2 percent in a very good year, to lose 8 percent of your business is very significant. That puts aside whatever the impacts are on the consumers, putting the travel onus on themselves.

So we think it is very major. Probably greater than any benefits we could have gotten.

Mr. CANADY. Thank you.

I have an additional question for Mr. Crandall. In your testimony, you recommended requiring the appointment of a trustee or new management upon the filing of a bankruptcy petition rather than permitting existing management to remain in place.

As you know, an important feature of the reorganization process under the existing Bankruptcy Code is that the court appoints a trustee only for cause or if certain preconditions are met. The National Bankruptcy Conference points out in an overview of its new code review project that "Chapter 11 embraced the idea of allowing the debtor to remain in control...subject to substantial court and creditor supervision. Automatically divesting the debtor of control would substantially discourage voluntary filings; debtors would file only when their businesses were hopelessly beyond repair."

So existing law is predicated on the assumption that a company's prospects for reorganizing successfully, at least in some cases, are greater with the maintenance of existing management in place.

In your view, Mr. Crandall, would it be appropriate to have one rule for reorganizations involving all industries other than the airlines and a separate rule for airline reorganizations?

Mr. CRANDALL. Well, I am not an expert on the Bankruptcy Code nor on industries other than the airline industry, so I really cannot address the latter question.

I think, as I said in my statement, that in the first place most airlines are publicly held corporations. I suspect that the board of directors of those companies, acting in their fiduciary capacity on behalf of shareholders, will not resist voluntary filings if that is the most appropriate course of action with which to protect the shareholder's investment.

As I indicated, a number of studies have been made of airline bankruptcy, and they have generally attributed airline failures to management failures. If a particular management has taken a carrier into a position of failure, and thus into a position where bankruptcy is required, it seems to me it is in the interest of the creditors and the shareholders—and will act to discourage adventurous managements from doing things that might not work—if management were automatically replaced.

I think that you would have fewer bankruptcies, and reorganizations would tend to be both speedier and more successful if management were replaced with a trustee.

Mr. CANADY. Mr. Ferguson, could you comment on that same subject?

Mr. FERGUSON. I don't concur with Mr. Crandall in this particular area. I do think that management should be given another opportunity.

With respect to the study Mr. Crandall cites, they were unable to get accurately the dates when companies filed for bankruptcy. They were unable to get accurately a whole long history of facts.

Nevertheless, there is some truth in what he says. And my view would be that the court is the proper forum for deciding whether the management of the company ought to be changed, not the law. The law allows that to be changed at the moment.

In my view, many managements are changed before a company goes into bankruptcy by the board of directors in an attempt to look at different strategies.

That management, if it is in place for a year, should that management be replaced simply because they were sitting there when all of the accumulation of things that had gone before happened?

I think that is unfair. I think the court is the proper forum, not the law.

Mr. CANADY. Thank you.

That is all I have, Mr. Chairman.

Mr. BROOKS. Mr. Berman, the gentleman from California, do you have any comments, questions?

Mr. BERMAN. Thank you, Mr. Chairman.

Mr. Crandall, my first question is, as one who flies just about every week on your airline across country, are you in fact pumping less oxygen into the airplanes? Because I feel like it.

Mr. CRANDALL. Are we what?

Mr. BERMAN. Pumping less oxygen into the airplanes?

Mr. CRANDALL. You are referring to the story in the New York Times.

Mr. BERMAN. I am. It all of a sudden explained everything.

Mr. CRANDALL. I hope not. As suggested in the article, as the years have gone by, we, other airlines, and the manufacturers of airplanes and engines have consistently sought to make them more fuel efficient. One of the ways in which we have done that is to change the airflows, which were described pretty well in that article.

The air quality in the aircraft is measured very often by the manufacturers, by the FAA, and by ourselves. Now, I suspect there are going to be a lot of additional studies as a consequence of that article, and if there is any truth to the notion that air quality has fallen below acceptable norms, we can at relatively modest fuel cost change the rate of air recirculation relative to the rate of new air intake.

But I do not think that you or anybody else would want to suggest we ought not to try and use aircraft fuel in the most efficient possible way.

Mr. BERMAN. I am not sure it is quality as much as sufficiency.

Mr. CRANDALL. There is plenty of air there, but the question before the House is air quality.

Mr. BERMAN. It was just something about reading that article and figuring out how I feel all the time.

Mr. CRANDALL. My wife said the same thing, "I am always falling asleep on these airplanes. Maybe this is why." I said, no, no.

Mr. LUBY. People feel that way when they walk through Congress.

Mr. BERMAN. That is right. We fall asleep in committee.

I came in late and didn't hear your testimony. Is the thrust of your testimony that the problem of the airlines is fundamentally about having to compete with chapter 11 operations that have a series of advantages under existing law, that thereby provide an effective form of subsidized competition, and were that problem removed, the industry would be restored to a healthy status?

Mr. CRANDALL. No, no, Congressman Berman. As we have developed in response to several questions here, I am not smart enough to know what, if anything, will restore the financial health of the U.S. airline industry.

I do think that the bankruptcy laws reflect an imperfection in the competitive marketplace which should be repaired. And I think, particularly, that it is very important for the Congress to focus on

the fact that a bankrupt carrier develops cost advantages which simply cannot be overcome.

Mr. BERMAN. I understood your point. I was trying to understand if—you may not be smart enough to know why, but you are smart enough to think of a variety of different things.

Is there anything other than what the Government is doing now that specifically you can point to as responsible for—

Mr. CRANDALL. Yes, there are several things. As we told the Commission, what the Government can do is quite limited. However, I think there are several things it can and should do.

Number one, I think it should fix the bankruptcy laws.

Number two, I think the government—by that I mean both the Federal Government and State and local governments—needs to stop thinking about the passenger as a movable taxpayer. We have laid on more and more taxes and fees, in an effort to raise money. The consequence has been to depress the rate of growth in air travel. As the rate of growth in air travel goes down, the economy—and the airline industry in particular—is penalized, because obviously we have bought the capital equipment in the hope and expectation that traffic will rise.

In addition to excise taxes which raise the price of tickets, there are a number of features of the Tax Code, notably the AMT, which causes us to pay cash taxes even in years when we lose very large amounts of money. That particular provision fails to recognize the uniquely capital-intensive nature of our business. We think those things should be fixed.

We think likewise that the air traffic control system can be—and Mr. Ferguson has alluded to this—much more efficient than it has been in the past, and we think that should be fixed.

And to come back to the chairman's point, there are genuinely egregious competitive disadvantages to which we are subjected by the actions of foreign governments which our Government should act much more aggressively to offset. If you are interested in those, they are an appendix to the recommendations we made to the Commission, and I have submitted them to this committee as an addendum to my testimony.

If you read that roughly 20 pages, it will literally curl your hair as to the kinds of advantages—curl it even more than it is. The fact of the matter is, it is quite outrageous, the advantages we have given to foreign airlines.

Mr. BERMAN. What percentage of your operating costs—and I don't know if this is the right way to describe it—go to landing fees?

Mr. CRANDALL. I don't know the answer. It is quite a small percentage.

Mr. BERMAN. Thank you.

Mr. BROOKS. Mr. Goodlatte, the gentleman from Virginia.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. Luby, I am interested in the recommendations that Mr. Crandall has regarding bankruptcy. I noted earlier you expressed the opinion that often reorganizations did not enable airlines to preserve their employment and thereby preserve their ability to contribute to the pension fund. I wonder if you agree with his proposal No. 4 that would deny them the ability to discharge those ob-

ligations or to reduce them, which effectively is a negotiated situation.

His position for doing that, to effectively allow the weight of that to push that airline out of business, I presume would be different than your position, which would be to try to preserve the pension fund in some fashion. And I wonder if you would have a hard and fast rule, as he proposes here.

Mr. LUBY. We—and here I am speaking on behalf of the AFL-CIO, not only the TWU—do not have a hard and fast rule. In 1984 we demanded of Congress that they develop a stricter standard for, in our case, rejection of collective bargaining agreements and modification of them. We have seen that standard abused.

And in my union's particular experience, the concessions that were exacted out of labor almost never resulted in the reorganization of the carrier, but over the long term did diminish the amount of money that was left over for payment of retiree welfare and pension contributions.

So I guess we would say that while we may not have a hard and fast rule, we do believe the present code has been abused and has acted to the detriment of the industry and its employees.

Mr. GOODLATTE. Would you support a change in the bankruptcy law as he suggests here?

Mr. LUBY. He has several suggestions.

Mr. GOODLATTE. No. 4 of his: "[T]he law should deny bankrupts the ability to discharge employee-related obligations, such as pension-fund contributions and medical coverage, and should limit their ability to reduce employee compensation."

Mr. LUBY. I don't think we have a position on whether they should deny the ability to discharge. We definitely do agree that they should restrict the ability to discharge those obligations.

I am not saying we would disagree with that. I am speaking on behalf of more than one organization here, and I just don't know what the overall position is.

But we have proposed in several different sessions stricter standards for rejection of those sorts of benefit, and I would add that we have talked about various competitive advantages that different airlines have had.

It is one thing when you develop those advantages through free collective bargaining. It is another thing when those advantages are imposed by a court and the court in essence becomes a partner of the bankrupt, thereby to the detriment of the other people competing against it. That is an unfair situation.

Mr. GOODLATTE. Thank you.

Mr. Crandall, in turn, as an airline executive I wonder what you think of Mr. Luby's proposal. I understand and recognize your recommendation No. 2, that you replace the management in the chapter 11 proceeding—but what about a ban on their ability to participate in the management of another airline in the future?

Mr. CRANDALL. Well, it seems to me that what an individual citizen of the United States does for a living ought not to be the province of the Congress. If the shareholders and directors of a new airline are prepared to hire Mr. X and Mr. Y to run that operation, I don't think the fact that that individual previously ran an airline that didn't work should prohibit them from doing that.

I assume that the shareholders will regard that individual with a certain jaundiced eye on the basis of their past lack of success, but I don't think the Congress ought to restrict the ability of individuals to do as they choose to do.

Mr. GOODLATTE. But I take it that you think the stockholders would be divested of all right to make that decision if they choose to go into a chapter 11 proceeding?

Mr. CRANDALL. I don't know that—once again, assuming that the law is changed to require the appointment of a trustee when a company enters chapter 11, when the board of directors and the shareholders decide to enter chapter 11, they, knowing what the law is, they are effectively signing up for a trustee.

Mr. GOODLATTE. Let me switch over to another topic. I share your concern about the competitive advantage British Airways may have gained. I agree with you that the investment they make is a separate issue from the rights that may have been bestowed here.

Now, do you think we should maintain this barrier to their entry to U.S. domestic markets, or do you think that the direction we should have is to continue to put pressure on these foreign governments to allow us similar access to their markets?

Mr. CRANDALL. I think it is very important to keep in mind that this is a business in which the United States—the U.S. market is about 45 percent of the total world aviation market. There is no country with which the United States can make a deal of our markets for their markets. And we ought to stop making such deals.

It is ludicrous, for example, to trade the right to fly in the Netherlands for the right to fly in the United States. That is the last deal the United States did. In my judgment, an absolutely ludicrous trade.

We ought to move towards open skies around the world, but the only way to do that, the only way to bring together a market large enough so that our carriers will have equivalent economic opportunities to theirs, is to go to a worldwide multilateral open skies aviation agreement.

The United States proposed exactly that kind of a multilateral worldwide open skies agreement in 1944 when the Chicago convention was adopted and the rest of the nations of the world rejected it. That is when we got into the present bilateral mode. I think if other countries want access to this market, they are going to have to give our carriers the right to build worldwide networks, because that is the only way we can compete.

Mr. GOODLATTE. You can't do it country by country. They can have access to our 45 percent if we are given access to the worldwide 50 percent?

Mr. CRANDALL. Exactly right. British Airways is in the business of transshipping goods and people by way of Heathrow to and from the United States and between the rest of the world and the United States. That is their business.

Now, I don't have any objection to their being in that transhipment business. But it seems to me that the carriers of the United States, since after all it is the U.S. market to which those goods and services are being transmitted, the U.S. carriers ought to have the right to be in the same business.

Mr. GOODLATTE. Thank you, Mr. Chairman.

Mr. BROOKS. Thank you very much.

Mr. LUBY. Can I add one thing, Mr. Chairman?

Mr. BROOKS. Very briefly. We have a time problem here. You all have longer answers even than the questions, if you can conceive of that.

Mr. LUBY. As you know, there are alcohol testing regulations that are going into effect now. Not a single other country in worldwide aviation has adopted those regulations.

Mr. BROOKS. The doctor cut me off in 1989. Prior to that, I had a pretty good average. But it is one of those things. There are also regulations for people who like to smoke. Now you have no smoking on flights from here to hell and back.

[Subsequently, Mr. Luby expanded his testimony with the following letter:]

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June 28, 1993

VIA FAX TRANSMISSION & FIRST CLASS MAIL

The Honorable Jack Brooks, Chairman  
Committee on the Judiciary  
Economic and Commercial Law  
Subcommittee  
B353 Rayburn House Office Building  
Washington, D.C. 20515

Dear Chairman Brooks,

I appreciate the opportunity to follow-up on my testimony before your Committee. In particular, I believe that any comprehensive examination of the problems of the industry must account for the regulatory burdens we place on our own domestic carriers, but fail to impose on their international competitors.

In this respect, I briefly referenced the expensive and comprehensive drug testing regulations, which will now be followed by an even more costly alcohol testing regime. Foreign carriers operating into this country will not have to deal with these costs, except to the extent that they employ U.S. citizens working in this country. Similarly, foreign carriers are entirely exempted from the FAA's new deicing procedures.

The Transport Workers Union has long been concerned about these examples of divergent treatment. We are alarmed, though, that these cost advantages are given to foreign carriers and operators in a context in which the Department of Transportation is actively considering enhancing their access to the U.S. market and, in fact, has already thrown the market for repair of U.S.

fleets open by eliminating all restrictions on the scope of maintenance work which can now be performed in foreign repair stations. These foreign stations are, of course, not covered by the above-referenced regulations.

I think continuation of this sort of policy poses a significant threat to the viability of the U.S. aviation and aerospace industry.

Sincerely,

*Arthur M. Luby*  
Arthur M. Luby  
Counsel, Transport Workers  
Union of America, AFL-CIO

AML:mjm

Mr. BROOKS. Thank you all very much, gentlemen.

I am glad to see Dave Mann here. He is one of finest lawyers we have on this committee.

Now our second panel includes Frank Lorenzo, chairman, Savoy Capital, Inc., a private investment firm located in Houston, TX. In the past, Mr. Lorenzo has been associated with several large and small airline companies.

Linda Golodner is the president of the National Consumers League.

Paul Stephen Dempsey is the Hughes Professor of Law and director of the Transportation Law Program at the University of Denver. Mr. Dempsey has written extensively on all aspects of the airline industry. Since 1979, he has been faculty editor of the Transportation Law Journal.

Gentlemen and Ms. Golodner, I want to thank you very much for being with us. We ask that you limit your oral statements to 5 minutes. We will include all of the written statements and we will have a few questions for you afterwards.

Mr. Lorenzo, Frank, good to see you again.

**STATEMENT OF FRANCISCO A. "FRANK" LORENZO, CHAIRMAN,  
SAVOY CAPITAL, INC.**

Mr. LORENZO. Thank you, Mr. Chairman, and thank you, members. Thank you for this opportunity to appear before the committee on this very important subject. I am going to just very briefly summarize my comments verbally. I have prepared written testimony.

Mr. BROOKS. Which will be in the record.

Mr. LORENZO. Today I am chairman of Savoy Capital, a private investment firm in Houston. Individually I am also an investor in a small airline startup here in the East.

By way of background, for 18 years I was chief executive first of Texas International Airlines and later of Continental Airlines in the 1980's.

In 1972, we acquired an interest in Texas International Airlines, which was a loss plagued small carrier. In those days, it was the smallest airline in existence at that time. We turned the airline around with route and cost structure changes and a number of marketing innovations aimed at the consumer, the most well-known of which were peanut fares.

I should point out to you we turned around and built this airline in an area of the world that had Southwest Airlines totally competing against us. And it was in this competitive environment that we built and saved, turned around and prospered this company.

In later years, we took interests in a number of other airlines that were struggling to succeed after deregulation. We also created a new airline in 1980. We created New York Air in the east coast, which was designed to provide a competitive, short haul, short to medium haul transportation in the East. That company was merged back into Continental Airlines in 1987 because the Government would not allow our ownership of two shuttles.

I think my record shows that most of the airlines that I managed successfully adapted to the new market forces unleashed by deregulation, and have therefore been able to survive the most chal-

lenging period in aviation. One, Eastern Airlines, was prevented from adjusting to the demands of the marketplace, by intransigent market forces, and subsequently failed.

The fundamental lesson inherent in this record, that companies in a deregulated industry must change and adapt to the market or face certain failure, illuminates the path before this committee as you scrutinize the current state of the air transportation system.

As one looks out at the industry today, clearly something is amiss. We don't have to go very far. We look out in the desert and see all the airplanes gathering dust; see the loss of carriers. As the chairman pointed out earlier, we also see the substantial numbers of furloughs from air carriers, and so forth.

However, the answer to the problem is hardly reregulation. In fact, quite the other extreme. It is clear to me that if there is an answer, the answer lies in looking at the consumer. It lies in looking at what the traveling public is doing and recognizing that what is happening today is that the consumer is not flying as much as it should or could or used to because of restrictions that are placed on airfares and the level of airfares. And what it really needs is a more unfettered marketplace than has been allowed over the last bunch of years.

In my written testimony I have laid out some statistics that we think are kind of interesting and have been implied by some comments made by some members earlier today. If you look at the period of time from 1981 to 1986, and you look at what fares did during that period, what costs did, what traffic did, and then compare it to a later period, 1987 through 1992, you can see some very interesting things going on, in my judgment.

In the earlier period, a period characterized by new entrants, adjustment to deregulation, much more competition, fares were down about 13 percent, costs were essentially flat, up about 5 percent, traffic was up 48 percent, and all this despite a recession that we are all familiar with in the early 1980's period.

Now, for sure, it did bring hardships to some carriers, carriers that were not able to adjust. We remember the Braniffs, for example. But there were successes in those times, as there are continuing today, and we are very familiar with Southwest.

In my judgment, the fact that Continental Airlines went into bankruptcy in 1983 and attempted to adjust to the marketplace and then came out in 1986 and paid its creditors 100 cents on the dollar is a classic example of the proper operation of the bankruptcy laws, and indeed the marketplace, in allowing competition to be enhanced.

In the 1987 to 1992 period, what we see is very lax antitrust enforcement. We see mergers of small, healthy, feisty carriers being gobbled up by the big carriers, carriers like Piedmont, carriers like Ozark, gone.

We see new entrants, small new entrants, because of predatory tactics, really not being able to survive—although and in many cases, their own management made major errors. But in any event we see a decrease in competition, and lo and behold, when you look at that 6-year period, you find the fares are up about 18 percent. Costs are up 23 percent. Traffic is barely up, up about 3 percent.

And the losses we are all familiar with; it is a staggering loss period.

I don't mean to imply that there is only one cause for these numbers. But it is clear that there is a relationship, in my judgment.

And so in any event we arrive at the situation of today where we have, in my judgment, regional oligopolies, regional monopolies, and an industry that in many cases prices air travel too high, or with too many restrictions because its costs are too high. One of the reasons its costs are too high is because of labor costs that are the product of a bygone era.

And the price structure that these carriers are left with is a price structure that increasingly the consumer is reacting to. Carriers are forced to resort to something that is a new art called yield management. Yield management means calling up and finding out that you have to stay over Saturday night in order to take a trip or that in order to get a fare that is economical you have to stay 2 weeks.

Today, in my judgment, there are ominous signs from the consumer that air transportation is not viewed as a value. Consumers, in my judgment, don't like what they see. Fares that are easy to get are too high. Fares that are reasonably low are too hard to get.

So what is happening? Consumers are voting with their feet. Traffic is not where it should be. And that is a problem. And that is why there is a lot of empty seats and more empty seats than has been expected.

I think one of the best demonstrations of the elasticity of what I am talking about is in any reasonable analysis of what is going on today, not nationally, because the competitive situation in this country is really rather different, if you look at certain regions, but if you simply look at the East compared to the West, in the East, over the last 10-year period, what you find is that competition is dramatically down. People's Express is gone. There is really no cost, low-cost competition.

What do you find? You find fares in short- to medium-haul markets, under about 500 markets, again over this 10-year period, for the top cities, top city fares are up 106 percent, fares more than double, up 106 percent. Traffic is down 12 percent. Over a 10-year period, traffic is down 12 percent.

In the West, again, over that same time period, and the West certainly had similar economic problems, particularly in recent years, and again, if you look at the top markets of the West, Los Angeles, Las Vegas, San Francisco, so forth, you find fares are flat, up 5 percent, and traffic, surprise, surprise, surprise, is up 75 percent during that same period. One part of the country traffic is up 75 percent, another part of the country, traffic is down.

In the West, we find vibrant competition. We find Southwest, we find America West. We find just a tremendous amount of competition taking place. Clearly deregulation is working in the West.

Deregulation is not the culprit. Deregulation has been a positive force. But it only is going to provide its maximum benefit when the elements of the free market are also encouraged, in my judgment.

As I said before, bankruptcy law is not the culprit. To listen to the large carriers, you would think that all the problems of the industry are the result of the chapter 11 carriers, and in my judg-

ment that is just nonsense. Chapter 11 provides a needed opportunity for adjustment of companies.

I do believe there are changes that can be made in chapter 11 law. I, for example, think that entrenched managements are allowed to remain too long in chapter 11 companies without a reorganization plan.

But I don't think that is a problem that airline chapter 11's monopolize. I think it well may be a problem with the law in general. But alleging that all the problems are as a result of chapter 11, I think, is just wrong.

Deregulation stimulated a change in the functioning of the marketplace. We need chapter 11 to allow those perhaps unfortunate companies that don't have the riches of other companies to adjust to the marketplace. I think we have seen, certainly at Continental Airlines, some of the positive results of that.

I am in the last couple minutes going to leave a few thoughts on improvement of the system, and I will just really concentrate on one. The rest of them are in my testimony.

Proper enforcement of antitrust laws over the last bunch of years would have made a dramatic change in this industry. The laws are on the books, but over the last bunch of years they have not been properly administered.

I must say I am tremendously impressed to see some of the improvements that the current administration seems to be taking in their attitude towards small airlines.

FTC enforcement is very important. We don't hear much about it, yet it has an enormous impact on the airline business. Enforcement is passed off to the Department of Transportation, which, in my judgment, does nothing about it. Yet, today airlines can go out and advertise fares, and then have only a few seats available.

This is just wrong. It tremendously penalizes the smaller airlines that do have prices and are offering genuine price alternatives, to say nothing of what it does to the consumer by forcing the consumer into a system of essentially bait and switch, where you call up to get a low fare that is advertised to find out there are no seats available, but by the way, at 9 at night there are plenty of seats available. If you are out in the economy, no supermarket would advertise Hershey bars for 25 cents and then have only a few bars available.

There are additional problems with slots, as has been duly noted before, but I won't take any more time of the committee. I know we are moving on to the lunch hour.

Suffice it to say, America has a great air transportation system today despite the cries of concern. We must not lose sight of the fact that we do have the safest, and most reliable aviation system in the world, and the improving economy will undoubtedly lead to improved financial results of the Nation's carriers.

Deregulation is a process, not an event. The process takes time. But if the Government takes the necessary steps to encourage competition and improve the position of the consumer, the improvements will be long lasting, in my judgment.

Thank you.

Mr. BROOKS. Thank you very much, Mr. Lorenzo.

[The prepared statement of Mr. Lorenzo follows:]

## Testimony of Frank Lorenzo

Subcommittee of Economic and Commercial Law  
United States House of Representatives  
June 9, 1993

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Mr. Chairman and members of the subcommittee, I am Frank Lorenzo, chairman of Savoy Capital, Inc., a private investment firm with diversified interests including an investment in a proposed new airline company in the Eastern United States, and, I was formerly chairman of Texas Air Corporation and Continental Airlines, Inc. Thank you for inviting me here this morning to express my views on the current condition of the airline industry.

By way of introduction, I assumed my first senior management post in the airline business in 1972 as President and chief executive for Texas International Airlines, a loss-plagued airline that we turned around by restructuring routes and costs, and by creating a number of new marketing initiatives. One of them was called 'Peanuts Fares,' a successful pricing experiment which offered customer's a 50 percent discount on fares and which ultimately encouraged the Civil Aeronautics Board to deregulate airline pricing. Subsequently, I took interests in air carriers that were struggling to survive, or had already failed, in the new economic environment created by the Airline Deregulation Act of 1978, and attempted to rejuvenate and build those carriers into companies that could compete and prosper. I was also responsible for the start of a new East Coast carrier in 1980, New York Air, a

successful company that was required to merge with Continental Airlines when Texas Air bought Eastern Airlines in 1986 because the Department of Transportation said we could not operate two airlines competing for the same shuttle traffic.

Most of the airlines I managed successfully adapted to the new market forces unleashed by deregulation and have therefore been able to survive the most challenging period in aviation; one, Eastern Air Lines, was prevented from adjusting to the demands of the marketplace by intransigent industry forces, and subsequently failed. The fundamental lesson inherent in this record - that companies in a deregulated industry must change and adapt to the market or face certain failure - illuminates the path before the committee as you scrutinize the current state of our national air transportation system.

Today I will confine my comments primarily to the dynamics of the domestic industry. A cursory analysis of the current state of affairs in air transportation indicates that something is amiss. Aircraft manufacturers have been sharply cutting back production as hundreds of unused aircraft gather dust. Most airlines are losing record amounts, furloughing experienced quality employees, reducing capacity and pulling back in what were once key markets. The average industry domestic fares, after a sharp decline in the early phase of deregulation, have climbed skyward, effectively pricing many Americans out of the market. Incredibly, total industry

traffic has declined from 1990 levels despite the half-price sale of 1992.

The current malaise in the industry is disconcerting, but not so disconcerting as some of the erroneous prescriptions, based on misguided theories, about how to address our problems. Of particular concern is the rush to regulate. For example, one foreign carrier came to town two weeks ago and advocated reregulation of fares. Reregulation, however seductive as a quick-fix, would do far more harm than good. In fact, reregulating the industry would merely lock into place the structural industry imbalances that are the source of the problems plaguing the American consumer today.

Exhibit one shows quite clearly what has transpired in the industry since Congress subjected a cozy regulated industry marked by high fares and relatively few passengers to competition and dictates of the market. The results of deregulation are striking: between 1981, the year of the first burst of new entry from deregulation, and 1986, average industry fares dropped 18 percent while traffic rose 48 percent -- importantly, costs only rose 5 percent. During this initial phase of deregulation, industry passenger revenue rose 28 percent. In other words, deregulation was working: for the first time in history of aviation, the average American citizen could afford to fly, and the airlines were successfully adapting by containing costs and stimulating demand.

Most importantly, the industry recorded profits of nearly \$150 million over this six year period, despite the effects of a severe national recession which ended in 1983.

Certainly, the great democratization of air transportation brought its hardships too: competition turned the hourglass on all those established carriers that possessed structural weaknesses, be it inefficient route structures as was the case with Pan American, or weak route structures combined with excessive expansion, as was the case at Braniff. It was only a matter of time before competition forced change or overwhelmed these venerable carriers. But other carriers learned to adapt swiftly to the consumer. Southwest Airlines, for example, utilized a low cost, short haul strategy with terrific success. Continental was transformed after its bankruptcy in 1983 into a lower cost, fast growing, and profitable airline, and yet managed to repay 100 cents on the dollar to creditors upon emerging from bankruptcy in 1986.

Nevertheless, after the initial wave of deregulation something interesting and unexpected happened to the industry. Around 1986, it began to consolidate, competition was reduced, and most of the low cost entrants which were most responsible for the downward pressure on fares left the market, particularly from markets east of the Mississippi. Part of the competitive instinct to adapt is to overwhelm and indeed eliminate competition when possible. And so, the dynamic of the industry was quickly reversed.

As the industry became increasingly dominated by big high costs carriers, average industry costs increased, (Exhibit 2) and so, naturally, did the average ticket price. Between 1986 and 1992, an era defined by carrier consolidation and a lack of new entry, fares increased 23 percent, costs increased 26 percent, and traffic expanded by a mere 9 percent. The benefits of affordable air transportation, so promising during the more competitive era of deregulation, were lost to the consumer. Coincident with this change in the structure of the industry came a change in profitability. Despite a significant drop in the price of fuel during the 1980s, the industry recorded staggering losses over the last six year period. (Exhibit 3)

And so we arrive at the situation we have today: an increasingly consolidated industry of regional monopolies or oligopolies that price air travel beyond the levels that permit many travel decisions in order to accommodate high costs, particularly labor costs, which are locked in, in many cases, by anachronistic contracts reflecting yesterday's pay rates and work rules. As a result, many carriers have been forced to rely on artificially high list prices, which few people pay, and the alchemy of yield management and other arcane airline practices to try to turn straw into gold. This also partially explains, somewhat paradoxically, why the industry has been forced to resort to massive sale extravaganzas once or twice a year. Aside from these sales, airline fares have become simply unattractive. Like a

finicky trout, the consumer waits and waits, and will not strike until fares are brought down to a level he or she finds appealing. Of course, the recession has also compounded this effect in recent years.

There are now ominous signs that the airline product as it is marketed today by most carriers no longer offers perceived value to many prospective consumers, and pales in comparison to the other products and services that compete with the travel dollar. For too many Americans, fares that are easy to get are too high, and fares that are reasonably low are too hard to get. Today, low fares also impose burdensome restrictions on the user: Saturday night stay requirements, advanced purchase requirements, nonrefundability, to name just a few.

The result is a byzantine user-unfriendly quilt of fares that is causing people to stay home, watch more movies, buy more stereos or if they are a business traveler, fax and teleconference more. The consumer is voting with their feet, and unfortunately, their feet are taking them away from the travel agencies and the ticket counters. For example, in the winter of 1992, the results of a national poll showed that 67 percent of adult Americans had no intention of buying another leisure ticket within the next 12 months. In other words, one hundred million Americans said "no thanks - I'll spend my money someplace else."

The elasticity of air travel demand is best illustrated, in our judgement by comparing the differences in market growth and fares in the east as compared with the west. Exhibit 4 sets forth data for top markets under 500 miles and compares them over a ten year period between the east and the west. Note that in the eastern markets, which have by and large not been served by a low- cost carrier since People Express, and indeed have lost service from several large carriers, fares have increased 106 percent, while passenger traffic has declined 12 percent. In the western markets under 500 miles, on the other hand, which are served by Southwest, America West and other low cost operators, fares have increased a modest 5 percent over the same ten year period, while traffic has increased 75 percent.

Clearly, deregulation in short to medium haul markets is working just fine in the west - unfortunately less than one-third of the nation's populace is reaping its benefits.

The same trend is evidenced in a comparison of two markets of very similar distance and population: San Diego to San Francisco, and Boston to Washington. In theory, there should be very little disparity between fares and traffic numbers in markets of similar demographics and economic history. But note that the average fare in the western market is \$53, while the average fare in the comparable eastern market is \$129. The low western fares are simply the function of increased competition, and the efficient

cost structures of the carriers that must compete.

So deregulation is not the culprit. Deregulation has been good for aviation, but it will provide its maximum benefit only when all the elements of a free market are encouraged.

Bankruptcy law is also not the culprit in my judgement. To listen to some of the large carriers, you would be led to believe that troubled carriers' ability to file for bankruptcy protection, and the cash flow advantage that it gives to ailing airlines, is at the root of the industry's problems.

However, Chapter 11 promotes competition and provides a proper opportunity for airlines, and indeed all companies, to gain the time necessary to reorganize an enterprise's financial and operating structure. While I do believe that the law allows bankrupt companies to stay in Chapter 11 too long under management's control, I don't believe the arguments alleging that bankrupt airlines are the cause of the industry's problems have any basis.

Deregulation stimulated the necessary yet massive changes in the economics of the airline industry. These forces continue to affect carriers today. It is imperative for the competitive functioning of the industry that Chapter 11 continue to be available for those carriers, hopefully few in number, who need the

time to redress finances or restructure operations -- or basically adapt to a new environment.

This brings me to some specific public policy initiatives that I believe should be considered to improve, on a long-term basis, the competitive functioning of the industry.

First, proper enforcement of existing antitrust and FTC regulations should be encouraged and will bring enormous benefits. As we've seen, after 1985, when healthy smaller carriers like Piedmont, Ozark and others were gobbled up by their larger competitors, without any antitrust restraint, the marketplace was denied the benefits of competition provided by these feisty, healthy carriers. In addition, lack of antitrust enforcement of industry predatory practices tripped up a lot of small startup airlines right out of the gate, thus denying the airline marketplace of a countervailing governor on costs, so critical to the health of the industry.

A destructive practice that has been allowed in the airline business, that is forbidden in other businesses by the FTC, involves low fare promotions. Because airlines can widely advertise a low-fare promotion and then make it available on only a few flights and seats, an unfair advantage is permitted to the larger, high cost carriers, which siphon away selling opportunities by holding out a false promise to the customer. This classic bait-and-

switch technique permits the higher cost airlines to generate tremendous phone call volume, and then "sell up", as it is called in the industry, to the higher fare. In turn, the low-cost producer loses the advantages that it has worked so hard to achieve.

This practice is not available in other industries because of FTC policing, which has been legislated to the DOT but largely forgotten. No supermarket today would post big signs in its windows advertising Hershey bars for 25 cents and then have only a few bars available. And yet the same practice is allowed in the airline business.

Enforcement of antitrust and FTC regulations will stimulate competition by encouraging new entry in the market. New entrants are powerful agents of change. They stimulate new investment from the private sector, ensure protection against regional monopolistic control at so-called fortress hubs, and can lead to across the board price reductions. Although new entrants presently comprise less than 5 percent of industry ASM's, they refocus the entire industry on the interests of the consumer. Witness what has occurred in the East in the past few months in short haul USAir markets. Some new entrants, and the prospect of others has, in my judgement, had a significant influence on US Air's recent decision to revamp their fare structure and lower unrestricted fares.

There is reason to be encouraged by the present

Administration's approach to antitrust regulation. Recent action by the DOT in defending Reno Air against initiatives of its much larger competitor is a hopeful sign that the Department is committed to stopping tactics that inhibit competition. But more needs to be done.

Second, a major factor limiting competition in the industry, particularly at the major airports in the northeast and in Chicago, is the unequal access to airports. The current system of airport arrival and departure "slots" make it very difficult for a new entrant to provide price competition at these slot-controlled airports. New entrants are forced today to pay exorbitant amounts simply to lease slots from incumbents who initially received these slots as entitlements from the FAA. Even though slots are rightfully the property of the American people, the system hardly works for the public benefit -- benefits fall instead to the entrenched incumbents.

The government has also been very slow over the last decade in policing abuses of slot rules and usage of slots. For example, many slots are controlled by incumbents who cannot make productive use of these slots. By "babysitting" slots -- using a slot just enough to satisfy the minimum usage requirement, often via subservice by a commuter -- effective competitive services are pre-empted.

The process under which incumbent airlines can tie up

attractive airport gates and facilities through long-term leases, and put new entrant competition at a decided disadvantage should also be reviewed.

All of these access issues need to be examined for their antitrust implications. And since the government funds so much of airport improvements through the ticket tax collected from passengers, it should take a greater and more active role in equalizing access to airports for the benefit of the consumer.

Thirdly, there is tax assistance which government could provide which would aid airlines and competition. An investment tax credit for Stage III airport noise compliance, either through re-engining or hushkitting older aircraft, or replacing them with new aircraft should be considered. However, recent proposals that would tie such credits to retiring twice the capacity covered by the credit are extremely ill advised and would operate to disadvantage financially weaker companies or faster growing small companies providing competition so vital to the consumer. Airlines that are growing and healthy should be encouraged.

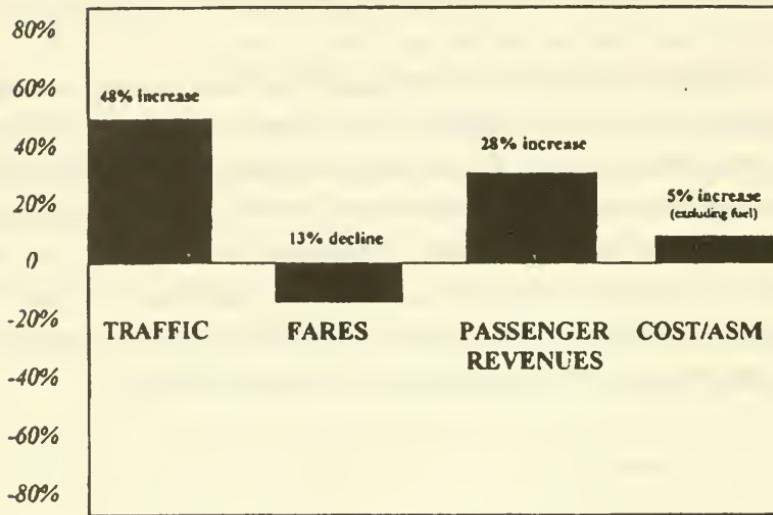
Lastly, government should consider the ways that some of the leftover characteristics from deregulation operate to hurt competition today by stifling smaller airlines. For example, the vast paper flow and information requirements, a holdover from the old days, that are imposed on all airlines put smaller companies at

a major disadvantage since large companies with their huge staffs and array of information processing capabilities are better equipped to learn details of a smaller competitor's business. The resulting imbalance of competitive knowledge hurts competition.

America has a great air transportation system today, despite the cries of concern. We must not lose sight of the fact that we have the safest and most reliable aviation system in the world, and the improving economy will undoubtedly lead to improved financial results of the nation's carriers. Deregulation is a process, not an event. The process takes time. But if the government takes the necessary steps to encourage competition and improve the position of the consumer, the improvements will be long lasting.

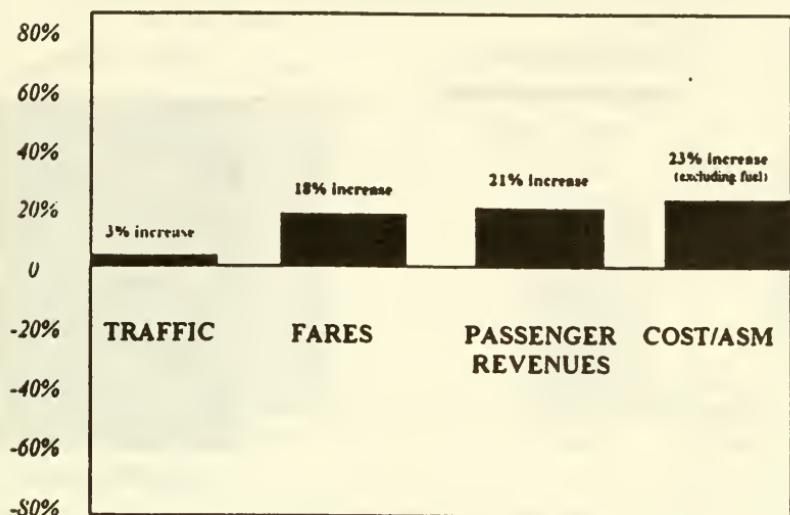
## Exhibit I - Industry Changes 1981 - 1986

*New Entrants Increased Competition  
And The Customer Reaped The Benefit*

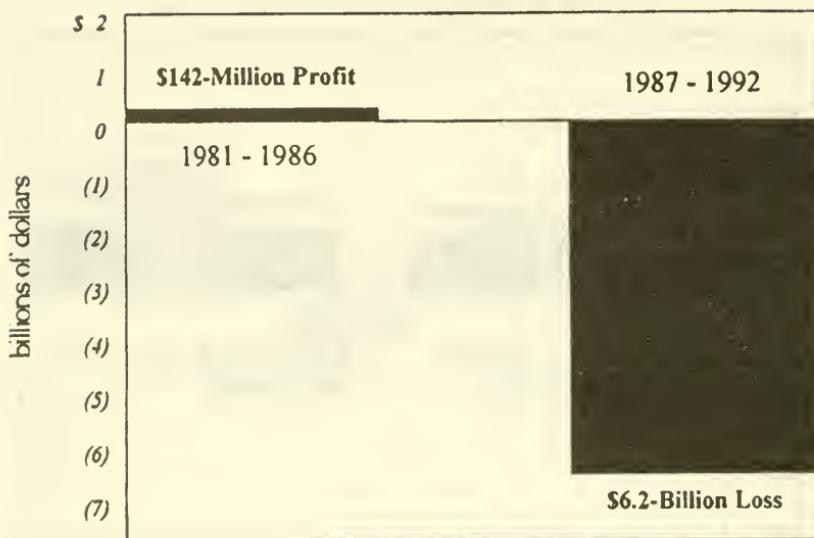


## Exhibit II - Industry Changes 1987 - 1992

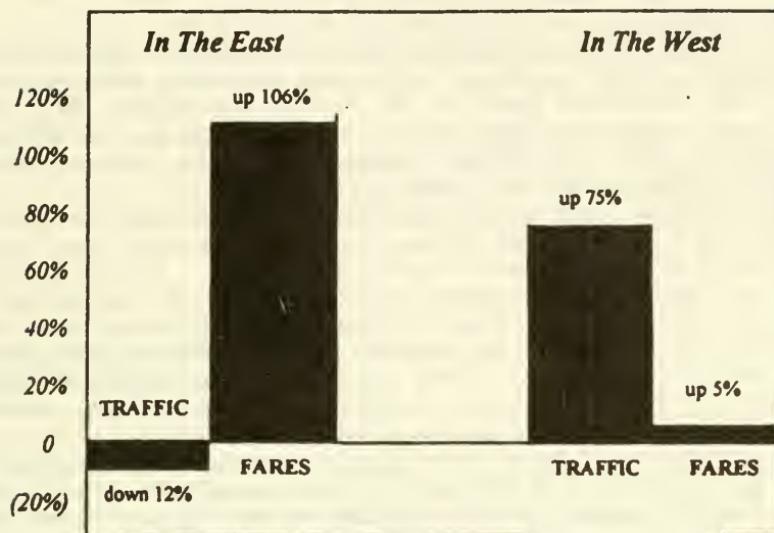
*The Industry Consolidated, The Customer Paid The Price  
And Traffic Growth Stopped*



**EXHIBIT III - Industry Profitability 1981 - 1992**  
*Competition Led To Profits*



**EXHIBIT IV - Traffic, Fares 1982 - 1992**  
*Major Short Haul Markets In The East Vs. The West*



Mr. BROOKS. Now we go to Ms. Golodner. We are glad to have you. We will put your statement in the record. Please proceed.

**STATEMENT OF LINDA F. GOLODNER, PRESIDENT, NATIONAL CONSUMERS LEAGUE**

Ms. GOLODNER. It will be 5 minutes, Mr. Chairman.

Mr. Chairman and members of the subcommittee, the National Consumers League is pleased to present testimony today on this timely and important issue for the American consumer. We commend your recognition that airline passengers are just as affected as business when competition thrives or when an industry needs government intervention to correct its problems.

The National Consumers League represents consumers on marketplace and on workplace issues. Our members come from every State. A great many are airline passengers.

We testified before Congress in the past on air transportation concerns, and while we closely follow aviation issues, we do not come here as experts on the aviation industry. We do come as experts on consumers and on their rights to be represented at hearings such as these, their rights to full information on fares, on safety, on choice of airline and choice of time to travel.

Consumers should be educated about these rights and be told up front about the rules of the game in purchasing tickets, and what service to be expected. And finally, they have a right to be assured that the Federal Aviation Administration is looking out for their safety and well-being by certifying only those airlines that provide consistent quality, safe service to their passengers.

Some of the things I want to discuss today are the Department of Justice consent decree. I would like to state up front that the National Consumers League takes no position on the merits or demerits of the Justice Department suit. We are concerned, however, that the remedy proposed by the Department of Justice, in attempting to punish the airlines, instead punishes the consumer.

Consumers know little about consent decrees or yield management programs or Tunney proceedings, but are people who want to obtain the most economical air travel possible. Generally these are people who pay for their travel out of their pockets and who rely heavily on and trust in travel agents to guide them through a very complex fare system. Often these consumers must plan far ahead for travel.

Planning, from the consumers' viewpoint, is the central weakness in the consent decree. In limiting information that travel agents and thus consumers can have in planning their travel, the decree deprives all travelers of basic data we have come to rely on to find the most economical and convenient fares.

I have listed in my prepared remarks several questions that the Consumers League wants to pose before the committee and before the Justice Department.

In sum, the prohibition on the flow of information to consumers denies them the opportunity to seek the most competitive fares on the basis of a range of acceptable travel times.

I received a call yesterday from the Consumers League of Ohio. They had heard from several dental students who had gone to pick up their tickets from a travel agent. They were \$75 more. They

were planning a group travel. When they arrived, the cost was \$75 more than originally quoted. We are getting complaints from a number of consumers, not only from the Ohio Consumers League, but from other consumers leagues around the country.

I quickly want to address the foreign-domestic airline partnerships we have seen arise. In today's marketplace, competition benefits all consumers. It creates new opportunities for providers and wider selection and lower prices for consumers. The air transport industry is no different.

We have learned before that when competition suffers, that consumers pay the price. Travelers will have fewer options in terms of convenience and low fares. And as one of the biggest airlines in the world with unmatched global reach, British Airways/USAir would have little, if any, incentive to offer the best service on routes it controls.

Unable to compete on an even footing, some U.S. airlines will find it difficult to survive. Hundreds of thousands of jobs will be at risk, along with the consumer benefits that flow from a highly competitive airline industry.

I want to touch now just to finish up my remarks on the competition among healthy carriers which we feel is best for consumers.

The National Consumers League is very concerned about the proposed reentry of a Frank Lorenzo airline into the marketplace. The plethora of bankruptcies and failures of companies of which he has been associated has been notorious.

While we support the Department of Transportation to encourage entry of new carriers to ensure a more effective and competitive airline industry, we hope members of the subcommittee will convey a message to the Secretary of Transportation that consumers do not want again to be the losers in a fiasco that may put our lives at risk with unsafe aircraft that leaves us stranded at airports, and again, at the bottom of the creditors' list.

We have touched on a few of the issues that we were concerned about, and would be glad to answer any questions.

Thank you.

Mr. BERMAN [presiding]. Thank you very much.

[The prepared statement of Ms. Golodner follows:]

TESTIMONY OF LINDA F. GOLODNER  
PRESIDENT, NATIONAL CONSUMERS LEAGUE  
BEFORE THE ECONOMIC AND COMMERCIAL LAW SUBCOMMITTEE  
COMMITTEE ON THE JUDICIARY  
U. S. HOUSE OF REPRESENTATIVES

OVERSIGHT HEARING ON COMPETITION IN THE AIRLINE INDUSTRY  
JUNE 9, 1993

Mr. Chairman and members of the Subcommittee, the National Consumers League is pleased to present testimony today on this timely and important issue for the American consumer. We commend your recognition that airline passengers are just as affected as business when competition thrives or when an industry needs government intervention to correct its problems.

The National Consumers League (NCL), our nation's oldest consumer group founded in 1899, represents consumers on marketplace and workplace issues. Our members come from every state; a great many are airline passengers. NCL has testified before the Congress in the past on air transportation concerns, and while we closely follow aviation issues, we do not come here as an expert on the aviation industry.

We do come as experts on consumers -- and on their rights to be represented at hearings such as these -- their rights to full information on fares, on safety, on choice of airline and choice of time to travel. Consumers should be educated about these rights and be told up front about the rules of the game of purchasing tickets. And finally, they have a right to be assured that the Federal Aviation Administration is looking out for their safety and well being by certifying only those airlines that provide consistent quality, safe service to their passengers.

Department of Justice Consent Decree

I would like to state up front that the National Consumers League takes no position on the merits or demerits of the Justice Department suit against ATPCO and the airlines. We are concerned, however, that the remedy proposed by the Department of Justice, in attempting to punish the airlines, instead punishes the consumers.

NCL expertise is in monitoring consumer behavior and assuring consumers -- especially persons who may not have other groups representing their views -- have a voice before regulatory and legislative bodies. We come to this proceeding to speak for the average consumer. NCL members are individuals who know little about consent decrees or "yield management programs" or Tunney proceedings, but are people who want to obtain the most economical air travel possible. Generally, these are people who pay for travel out of their own pockets and who rely heavily on, and trust in, travel agents to guide them through a very complex fare system. Often these consumers must plan far in advance for travel. It is the grandmother who has only flown once or twice in her life who wants to see her new grandchild; it is the couple who have finally retired on a fixed income that stretches to allow them only one or two special trips a year; it is the two-earner family that must watch every penny for the promised family vacation to Disneyworld.

I want to emphasize the word "plan." Because that -- from the consumer's point of view -- is the central weakness of the consent decree proposed by the Justice Department. In limiting the

information that travel agents, and thus consumers can have in planning their travel, the consent decree deprives all travellers of basic data we have come to rely on to find the most economical and convenient fares.

We have spent most of our existence as a consumer group supporting the belief that consumer information and education are critical to an efficient and open marketplace. The proposed consent decree runs counter to our efforts to promote just that. Restricting information as proposed by the Justice Department will severely limit consumer choice and skew the marketplace by forcing travellers to make spur-of-the moment decisions with the luxury of considering their purchase and cheating them out of choosing the best deal possible on an often-tight budget.

In fashioning its consent decree, the Justice Department has not thought through the consequences of such a scheme on the travelling public. There are a number of important questions NCL would like answered:

1. Credit card companies and consumer groups alike spend a great deal of time encouraging consumers to use their credit wisely. We tell them that interest on a purchase should be a family budget item. The practice the consent decree will force people into is to pay cash on the line or pay additional interest thus increasing air fares because of uncertainty created about ticket prices and having to buy now. Our question is: has the Justice Department considered the overall economic impact on families if they are no longer able to use this tool in managing

their money?

2. Because the airlines will no longer be allowed to inform customers of the expiration date of discount fares unless they also communicate this information in advertising or direct mail campaigns, won't this encourage airlines to cut back on discounts and ultimately raise fares?

3. To the extent that airlines do increase their advertising so that they can announce the expiration date of discount fares, won't those increased costs be passed on to the consumer in the form of higher fares?

4. How will the proposed consent decree affect programs particularly important for senior citizens -- for example, the senior coupon system, bereavement fares, or other discount programs?

5. Will the proposed consent decree apply to a ticket that includes both a domestic and an international leg? How will the proposed decree affect domestic travel versus international? Will a traveller have advance notice of price changes for an international leg of a trip, but not for the domestic leg?

6. Won't the consent decree create a sort of "insider information" network about future fare increases, and will this adversely affect individual consumers in comparison to large corporate clients of the airlines? Most consumers are not going to call their travel agent every day, practice double booking, or cancel and ask that tickets be reissued.

We can probably come up with many more questions that the

Justice Department does not address in its filing. This is an extremely complicated issue; tinkering with the system without adequately studying the many ripples being created can be dangerous and self-defeating.

In sum, the prohibition on the flow of information to consumers denies them the opportunity to seek the most competitive fares on the basis of a range of acceptable travel times. With full disclosure and knowledge of first and last ticket dates, consumers can adjust their travel dates and/or purchase dates in order to take advantage of the lowest fares. Without this information, consumers must "roll the dice" in deciding when to buy tickets. The consent decree clearly denies consumers the ability to make informed purchases of air travel.

#### Foreign/Domestic Airline Partnerships

In today's marketplace, competition benefits all Americans. It creates new opportunities for providers and wider selection and lower prices for consumers. The air transport industry is no different. Yet, transactions such as that proposed by the agreement between USAir and British Airways might find that the Department will have mortgaged the long-term future of the U.S. air transport industry for a short-term improvement of USAir's balance sheet.

We have learned before that when competition suffers, consumers pay the price. Travelers will have fewer options in terms of convenience and low fares. And as the biggest airline in the

world, with unmatched global reach, British Airways/USAir would have little, if any, incentive to offer the best service on routes it controls. Unable to compete on an even footing, some U.S. airlines could soon find it difficult to survive. Hundreds of thousands of jobs could be at risk, along with the consumer benefits that flow from a highly competitive airline industry.

Competition Among Healthy Carriers Is Best for Consumers

The National Consumers League is very concerned about the proposed re-entry of a Frank Lorenzo airline into the marketplace. The plethora of bankruptcies and failures of companies with which he has been associated is notorious. Workers, creditors, consumers suffer when an airline goes under. Passengers not only are left stranded at airports but they are also put at the bottom of the creditors lists. In addition, there are allegations that these companies cut corners on maintenance and safety measures threatening the safety and well being of passengers and crew. NCL not only represents consumers in the marketplace, but we recognize that worker safety and security are important. Workers are consumers and must be paid a decent wage and have the security of knowing their job and their pension is secure.

While we support the Department of Transportation policy to encourage entry by new carriers to assure a more effective and competitive airline industry, we hope that members of this Subcommittee will convey a message to the Secretary of Transportation that consumers do not want to again be the losers in a Lorenzo fiasco that may put our lives at risk with unsafe

aircraft, that leaves us stranded at airports, and again at the bottom of the creditors list.

Mr. Chairman, we have touched on a few issues of concern to consumers in our testimony today. We thank you for the opportunity to present our views and will be happy to answer any questions of the Subcommittee.

Mr. BERMAN. We have a Journal vote, and Chairman Brooks suggests if it is all right with the panelists, that we recess and come back to hear Professor Dempsey's testimony and be able to ask questions. Is that OK with everyone? Mr. Lorenzo.

Mr. LORENZO. Unfortunately, I have a commitment at 12:30. I could come back after that, but I have to leave at 12:30.

Mr. BERMAN. Well—

Mr. LORENZO. Can I be excused? Any questions?

Mr. BERMAN. I had a question I wanted to ask you. If you are not going to be able to be back—

Mr. LORENZO. I could be back after 2.

Mr. BERMAN. We have 5 minutes, so Professor Dempsey, would you let us—

Mr. DEMPSEY. I will defer.

Mr. BERMAN. I will ask the question, and welcome back.

I think out of courtesy you should have a chance to respond to Ms. Golodner's comments, but very specifically, you are a controversial figure in the industry. You made some suggestions, some of them seemed particularly strange given your own background. You talked about more rigorous enforcement of antitrust laws, but you talked about owning two shuttle commuter airlines at the same time and bemoaned the forced sale of New York Air for presumably antitrust reasons.

You spoke about accepting one element of the first panel's suggestions or Mr. Crandall's suggestions about more quick change of management of airlines that file for bankruptcy, but you held management of airlines in bankruptcy for a considerable period of time.

I would just be interested in your reactions to these issues.

Mr. LORENZO. Mr. Chairman, I would first point out to you that we did own two shuttles in 1987, but one of them I created. One of them didn't exist before the entrepreneurial efforts that I particularly put forward in 1980 in the creation of New York Air, which I think is exactly what the American system is supposed to produce.

I would point out—

Mr. BERMAN. At that time you owned Eastern?

Mr. LORENZO. At that time we had signed a contract to acquire Eastern. Government did exert antitrust effect then, yes, but my point is that there is much more that should have been done.

We never got involved with healthy airlines. In fact, most of the companies we acquired were companies that were either headed out of business or were already out of business, in the case of Frontier Airlines, which was grounded and planes were parked, or were very close to it, in the case of People Express.

My history of 18 years in this business is a history of acquiring and being involved in companies that were in very serious financial positions, starting with Texas International, that had lost \$20 million before I walked in the door, and we turned around—we turned the company around by appealing to the consumer and by changing and adapting the company to the marketplace, and the marketplace in Texas, as I mentioned, was very much affected by Southwest.

The same is true for Continental Airlines, which had lost hundreds of millions of dollars when we walked in the door, and East-

ern Airlines in 1986. Everybody in this world knew about the problems of Eastern Airlines. It had lost almost \$1 billion from deregulation, up to the time we walked in the door. We did not have a long period in bankruptcy.

Every bankruptcy should work out, Mr. Chairman, like the bankruptcy of 1983 where we paid our creditors 100 cents on the dollar. And if you can find a creditor that complains about the Continental bankruptcy of 1983, I will point you to someone who still believes in the tooth fairy.

Mr. BERMAN. A couple questions the chairman would like to get on the record.

Mr. LORENZO, which parties do you believe have benefited and which have been harmed as a result of airline deregulation?

Mr. LORENZO. The consumer has been helped by airline deregulation, but my point and the point of my testimony today is that it has not been helped as much as it could be because the marketplace is not functioning properly.

We talk about average tickets and we don't talk about restrictions that we put the average person through today. We have a system which needs more competition.

Why is Southwest Airlines successful? I would tell you that one of the major reasons why Southwest—and I can tell you, I don't own any stock in Southwest Airlines—but the reason why that company is successful is because it is providing the consumers what the consumer of this country today is begging and begging for, if you would only spend a minute to listen to it. They are begging for honest, dependable, low cost, attractive air transportation. That is what Southwest is providing the consumer.

The consumer today is less and less interested with picking up the phone and finding out it is \$300 today to fly from Washington to Boston and then if you want to get a reasonable fare of \$100 or \$150, you have got to book 2 weeks in advance, you have to stay over Saturday night or you have to go via Little Rock or whatever. That is the system that we have evolved into. And the consumer has reacted to it.

Now, there have been parties that have been harmed. Deregulation was not designed to make shareholders thrilled. And shareholders have had to go through the burden of change. It has been very costly in many cases. The same thing with labor.

Unfortunately, what companies could afford in the cozy days of regulation was not the same of what they could afford in the marketplace realities of 1980. It is very tough, it is very sad, it is very difficult.

And no situation was more difficult than Eastern Airlines, a company that had lost nearly a billion dollars when we walked in the door, but clearly couldn't afford what it was doing. And we had to come in and we were unfortunately the ones who blew the whistle and said, Hey, wait a minute, fellows, this game can't continue, this company is headed out of business. We need change, we need to adapt.

I can tell you it was very, very difficult to have to walk up to an employee that couldn't go and carve one room off his house or eliminate one of his children, when we had to say that the company

couldn't afford to continue paying \$50,000 a year to unskilled laborers, for example.

Mr. BERMAN. I would like to pursue this longer but given your schedule and the fact that if I don't leave I will miss the vote, I am going to have to call a recess.

Mr. Fish asked unanimous consent if he could submit some questions to you in writing for responses, which could go in the record, and the chairman as well.

Mr. LORENZO. I would be delighted.

Mr. BERMAN. The chairman will be coming back afterwards to hear Professor Dempsey's testimony, and pursue whatever panelists remain with questions.

Thank you.

[Recess.]

Mr. BROOKS [presiding]. The subcommittee will come to order.

The Chair recognizes Mr. Dempsey.

Professor, we are delighted to have you here. We will put your statement in the record. We appreciate your comments at this point.

#### STATEMENT OF PAUL STEPHEN DEMPSEY, HUGHES PROFESSOR OF LAW AND DIRECTOR OF THE TRANSPORTATION LAW PROGRAM, UNIVERSITY OF DENVER

Mr. DEMPSEY. Chairman Brooks, distinguished Congressmen, it cost me \$1,005 to fly here from Denver in coach. Nevertheless, the airline industry is losing money unmercifully. The airline industry has not only lost all money it made since the Wright brothers flew from Kitty Hawk, NC, in 1903, it has lost two and a half times all the profit it ever made.

After more than 100 bankruptcy and 50 mergers, we now fly the oldest and most repainted fleet of aircraft in the developed world. Ninety-seven percent of the industry's debt has been relegated to junk bond status. As Wall Street analyst Julius Malduits recently said, if the airlines were savings and loan institutions, the Government would put them into receivership and liquidate them. The parallels between savings and loan deregulation and airline deregulation are unfortunate and many.

The public interest in this industry is paramount. We are talking not about an industry that produces lipstick. We are talking about an industry that is the very veins and arteries of commerce, communications, and national defense. Therefore, a weakened infrastructure industry is not in the long-term best interest of the Nation.

Second, the industry has a chronic tendency to engage in below cost and highly discriminatory pricing, exhibited over a long period of time.

I urge you to take a look at the very last page of my testimony. It is a chart which shows the airline industry's annual net profit margin over a period beginning in 1960. What you see there is that the profit margin under regulation was by no means robust. It was a mere 2.5 percent profit margin, on average.

But under deregulation, it is catastrophic. Even taking out the last 3 years, the profit margin in the post-deregulation period is three-quarters of 1 percentage point. It should be between 4 and

8 percent in order to have responsible debt-to-equity ratio, which it does not now have.

I also want to point out that this condition is not a historical anomaly triggered by the spike in fuel and the recession of the late 1980's. It was worsened by those events, but those events did not create the catastrophic economic condition of the industry.

I will point out, in looking back at that chart, that in the early 1970's the country suffered much the same—an introduction of excessive capacity with the massive purchases of large numbers of wide-bodied aircraft, the recession which dampened passenger demand, and fuel costs. In fact, fuel costs doubled in the 1970's. Yet in the early 1970's no airline went bankrupt.

In the food chain one must also recognize that the health of the aircraft manufacturing industry, which is our Nation's single most important manufacturing export, and the health of the airports are directly dependent upon the health of the airlines.

Now, Congress has created and the President has helped appoint a Commission To Preserve a Strong and Competitive Airline Industry. Recently one of the chief executive officers of the industry testified before that Commission, and he said, "I am increasingly pessimistic that this can be a strong *and* competitive airline industry."

Now, what that means is it could be weak and competitive, which it now is. It could be strong and concentrated, which it might be. Or worse still, it could be weak and concentrated, which it might one day be.

Now, having said all that, one might think I am an advocate of returning to 1938 public utility regulation. I am not. And I am not for several reasons, the most salient of which is simply that the eggs have been sufficiently scrambled that we cannot put them back in the shells again. The industry's cost structure is no longer homogeneous. It is heterogeneous, and therefore pricing regulation of the kind we saw before 1978 would be extremely difficult.

You have a number of alternatives before you. One is a Government bailout. A number of people have argued we should have some kind of a direct or indirect taxpayer contribution—for example of a rollback in ticket taxes, a reduction in the alternative minimum tax, or loan guarantees for new aircraft purchases. I support those, too, but only if the taxpayers' investment is protected.

That is to say, there must be a comprehensive solution to the airline industry's problems, or otherwise Congress will have done what was done to the savings and loan institutions. The airline industry is perfectly capable of squandering any kind of taxpayer contribution in a new round of fare wars.

If we do nothing, we will continue to see a continuing downward spiral of operating losses, diminished equity, and increased leverage. The top three airlines require about \$15 billion of equity merely to get their balance sheets up to a 50/50 level. The airline industry has never made that kind of money.

We could sell off the airline industry to foreign citizens and their governments. If we do that, recognize the national security implications of it.

And finally, some people have suggested we should have a more vigorous enforcement of the antitrust laws. I wrote law review articles in the mid-1980's advocating that as well. I expressed extreme

displeasure with the Department of Transportation's approval of each and every one of the 21 mergers that was submitted to it in the mid-1980's.

They were approved for all the wrong reasons, but I have now come full circle. I now believe the economic condition of the industry would be worse today had the antitrust laws been effectuated in order to disapprove those mergers. Nonetheless, I applaud DOT Secretary Pena's recent effort to protect Reno Air from Northwest's predatory behavior, and antitrust enforcement of that nature should be welcome.

You are going to get all this kicked back to you. Congress is going to have to deal with this problem. I am not optimistic that the National Commission will do more than suggest that we rearrange the deck chairs on the *Titanic*.

I would suggest to you that you identify your objectives first, and I would submit that they should be three.

The first should be to rectify the financial crisis in the industry.

The second should be to promote consumer equity.

And the third would be to allow new firms reasonable entry opportunities.

I do not suggest you publish or read all of my lengthy testimony, but I would urge to you read the conclusions, because in them I suggest 16 different ways to accomplish those three objectives.

I see my 5 minutes are up, Mr. Chairman.

Mr. BROOKS. I want to thank you very much.

[The prepared statement of Mr. Dempsey follows:]

**AIRLINES, AVIATION & PUBLIC POLICY**  
**THE NEED FOR LEGISLATIVE REFORM**

by

**PAUL STEPHEN DEMPSEY**

Hughes Professor of Law  
Director, Transportation Law Program  
University of Denver College of Law  
1900 Olive Street  
Denver, CO 80220 U.S.A.

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**TESTIMONY BEFORE THE**  
**SUBCOMMITTEE ON ECONOMIC AND COMMERCIAL LAW**  
**OF THE**  
**HOUSE ANTITRUST COMMITTEE**

June 9, 1993

Washington, D.C.

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Paul Stephen Dempsey is Hughes Professor of Law and Director of the Transportation Law Program at the University of Denver. He formerly served as an attorney with the Civil Aeronautics Board and the Interstate Commerce Commission in Washington, D.C..

Professor Dempsey has written nearly forty law review articles, scores of newspaper and news magazine editorials, and several books: AVIATION LAW & REGULATION (two volumes, Butterworths 1993); AIRLINE DEREGULATION & LAISSEZ FAIRE MYTHOLOGY (1992); FLYING BLIND: THE FAILURE OF AIRLINE DEREGULATION (1990); THE SOCIAL AND ECONOMIC CONSEQUENCES OF DEREGULATION (1989); LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION (1987); and LAW & ECONOMIC REGULATION IN TRANSPORTATION (1986).

Dr. Dempsey holds the following degrees: A.B.J., J.D., University of Georgia; LL.M., George Washington University; D.C.L., McGill University. He is admitted to practice law in Colorado, Georgia and the District of Columbia.

Professor Dempsey was a Fulbright Scholar, was awarded the Transportation Lawyers Association Distinguished Service Award, and was designated the University of Denver's Outstanding Scholar. He was the first individual designated the University of Denver's Hughes Research Professor and DePaul University's Distinguished Visiting Professor of Law. Since 1979, he has been faculty editor of the Transportation Law Journal.

Since 1986, he has been the host of KWGN-TV's weekly talk show, "Your Right To Say It." Professor Dempsey has appeared on the ABC Evening News with Peter Jennings, the MacNeil-Lehrer News Hour, ABC World Business Report, NBC Today, CNN Crossfire, National Public Radio, CBS Radio, NBC Mutual Radio, and other news broadcasting networks in the United States and abroad. His editorials have been published numerous newspapers and news magazines, including the following:

- o Arizona Republic
- o Atlanta Journal & Constitution
- o Baltimore Sun
- o Boston Globe
- o Charlotte Observer
- o Chicago Tribune
- o Christian Science Monitor
- o Cleveland Plain Dealer
- o Dallas Times Herald
- o Denver Post
- o Des Moines Register
- o Dallas Times Herald
- o Ft. Worth Star Telegram
- o Houston Chronicle
- o Houston Post
- o Los Angeles Times
- o N.Y. Journal of Commerce
- o New York Times
- o Newsweek
- o Philadelphia Inquirer
- o Rocky Mountain News
- o Seattle Times
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**AIRLINES, AVIATION & PUBLIC POLICY**  
**THE NEED FOR LEGISLATIVE REFORM**  
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**AIRLINES, AVIATION & PUBLIC POLICY: THE NEED FOR LEGISLATIVE REFORM**

by Paul Stephen Dempsey\*\*

***I. INTRODUCTION***

Airlines were among the first of the major infrastructure industries to be deregulated, with the promulgation of the Airline Deregulation Act of 1978. In that legislation, Congress took the unprecedented step of sunsetting a major regulatory agency -- the Civil Aeronautics Board, which had been established four decades earlier.

Beginning in the Carter Administration, and perfected to an art form in the Reagan Administration, federal oversight of industries as diverse as airlines, busses, railroads, trucking, telephones, cable t.v., radio and t.v. broadcasting, banking, savings and loans, and oil and gas was significantly trashed. The virus of deregulation was politically contagious.

The means applied to transform and radically shrink government proceeded along two planes, sometimes independently. Congress passed major legislation mandating various forms of deregulation between about 1976 and 1985, while successive Presidents appointed free market ideologues to the regulatory agencies with the mission essentially to exceed their legislative mandates and ignore their oaths of office.

The laissez-faire economists who convinced Congress to promulgate the Airline Deregulation Act of 1978 promised that deregulation would result neither in increased concentration nor destructive competition. This was true, they insisted, because the industry was structurally competitive, possessed few economies of scale, and was impeded by few barriers to entry. But compare those predictions and assurances with the unfortunate results of deregulation:

- o Under deregulation, the airline industry lost all of the money it made since the Wright Brothers' inaugural flight at Kitty Hawk in 1903, and several billion dollars or more.
- o After more than 150 bankruptcies and 50 mergers, we now fly the oldest and most repainted fleet of aircraft in the developed world.
- o Nearly 20% of the nation's fleet capacity is in bankruptcy.
- o Of the scores of airlines to which deregulation gave birth, only one remains (America West) and sadly, it too, is in bankruptcy.
- o United, American, Delta and Northwest now control nearly three quarters of the market, up from 42% in 1985.
- o All the U.S. airlines together are now worth less on Wall Street than Japan Airlines, individually, is worth on the Nikkei.
- o Despite predictions to the contrary, deregulation has produced the highest level of national and regional concentration in history.
- o Although more people are flying than ever before, the percentage increase in domestic airline passenger enplanements was lower during the first decade of deregulation than in every decade which preceded it.
- o While most passengers now fly on a discounted ticket, the full fare has risen sharply under deregulation, more than double the rate of inflation. The discounts are now encumbered with onerous prepurchase, nonrefundability and Saturday-night-stay-over restrictions. They are therefore an inferior product to the passenger flexibility offered under regulation.

o Despite allegations to the contrary, average real fuel-adjusted ticket prices are higher than they would have been had the pre-deregulation trend of falling prices continued. Under deregulation, pricing has also has grown monstrously discriminatory.

o For example, it recently cost less to take a taxi than fly from St. Louis to Kansas City, for the 90 cent a mile cab fare was lower than the \$1.00 a mile plane fare. It cost less to take a bus from Atlanta to Birmingham, and there catch a flight to Atlanta and connect on to New Orleans, than it cost to fly from Atlanta to New Orleans nonstop.

o Industry costs increased sharply under deregulation, while the long-term trend in productivity improvements fell flat.<sup>1</sup>

o Hubbing-and-spoking, the dominant megatrend on the deregulation landscape, has caused air travel in some markets to regress back to the DC-3 era, robbing aviation of its inherent advantage and man's most precious commodity -- time. Business travelers lose billions of dollars in productivity as a result of circuitous and time-consumptive hub-and-spoke operations.

o Under deregulation, service has declined, while consumer fraud has increased.

o Although fatality statistics do not reflect it (thank God), the margin of safety has also declined.<sup>2</sup>

o Labor-management relations have deteriorated.

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<sup>1</sup> Airline operating expenses increased 94% during deregulation's first six years. U.S. GENERAL ACCOUNTING OFFICE, HIGHER FARES AND REDUCED COMPETITION AT CONCENTRATED AIRPORTS 24 (1990). Productivity improvements preceding deregulation fell flat after it. See R. Gordon, Productivity in the Transportation Sector (unpublished monograph 1991).

<sup>2</sup> Alfred Kahn has confessed, "There have of course been severe problems and reasons for concern even from the public's standpoint: most prominently sharply increased congestion and delays, increased concentration at hubs, monopolistic exploitation of a minority of customers, and possibly a narrowing of the margin of safety. . . ." Kahn, Airline Deregulation -- A Mixed Bag, But A Clear Success Nevertheless, 16 TRANSP. L.J. 229, 251 (1988).

- o Americans now rate airlines as the industry with which they have least confidence.

Neither economic nor equity goals have been advanced by deregulation. The assumptions upon which it was based -- that there were few scale economies in aviation; that destructive competition in this industry was unlikely; that "contestability" of markets (the purported ease of potential entry) would discipline pricing -- the three legs of the theoretical stool -- have proven false. Remarkably, despite the disintegration of the intellectual foundation of deregulation, its proponents swear the thing works.

Deregulation is a rather peculiar phenomenon. Its most fervent proponents continue to embrace it, not merely as an abstract economic theory, but with political, almost theological, devotion. No matter what evidence is adduced of widespread failure (and there is plenty), they tenaciously insist such evidence can be reinterpreted as success. Some go so far as to assert that its failures can be attributed to a belief that we didn't deregulate enough.

The free market, laissez-faire movement has earned a special place in history. Not since the Bolshevik Revolution has the discipline of economics embraced an ideology with such passion.

With the collapse of Marxism in eastern Europe, no advocate of responsible public policy today advocates that government should apply command economy-type restrictions over price and supply. But some, including this author, do believe the appropriate level of government oversight for this critical infrastructure industry lies somewhere between the regulatory regime established for airlines in 1938, and the contemporary environment of laissez-faire market Darwinism.

## II. *THE HISTORY AND METAMORPHOSIS OF AIRLINE REGULATION AND DEREGULATION*

### A. INTRODUCTION

Aviation is among the most profound of man's technological accomplishments. Like no other invention, it collapses the time/space continuum. Aviation shrinks the planet, intermingling the world's cultures and economies. It is an integral part of the infrastructure essential to commerce, communications and national defense.<sup>3</sup> Aviation is mobility for the human race, facilitating travel and tourism, the world's largest single industry.

In October 1902, a couple of bicycle repairmen, Wilbur and Orville Wright, began to design the world's first motor driven airplane. Men had flown in balloons for decades, but the Wright brothers had something quite different in mind. On December 17, 1903, at Kitty Hawk, N.C., they successfully launched their oddly shaped vehicle into the air, and the world has never been the same since.

### B. THE EARLY AIRLINES, FEDERAL SUBSIDIES AND AIR MAIL REGULATION

From its inception, the airline industry has been perceived as having tremendous potential as a catalyst for economic growth, and an essential means for facilitating communications and national defense. Early on, the U.S. government recognized its potential to serve the needs of a growing nation. As a consequence, our federal government has been active in promoting and encouraging its growth and development from the outset.

The government's responsibility to carry the mail as an essential means of communications was recognized by the framers of the U.S. Constitution, and embraced by that document. The compelling need for expeditious mail service led the Post Office Department to develop the Pony Express, and to employ advanced technology as it emerged, beginning with the railroads.

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<sup>3</sup> P. DEMPSEY, *LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION* 1 (1987).

The United States air transport industry owes its initial development to subsidies for carriage of the mail. As we shall see, the route structures of the largest airlines -- United, American, TWA and Eastern -- were largely the product of air mail contracts awarded by the Post Office Department in the 1920s and 1930s. Passengers rode on top, while mail was carried in the belly of aircraft.

Air mail service was inaugurated by the Army in 1918, on a route from New York to Philadelphia to Washington, D.C.<sup>4</sup> By 1920, transcontinental route from Hazelhurst Field, N.Y., to San Francisco, Calif., had been established.<sup>5</sup> By 1924, the Post Office Department had constructed nearly 2,000 miles of lighted airways, allowing pilots to make regular transcontinental night flights.<sup>6</sup> The first pilots were daredevils; sadly, 31 of the first 40 pilots in airmail service died in crashes.<sup>7</sup>

By the mid-1920s, Congress decided to privatize the carriage of mail. The Kelly Act (Contract Air Mail Act of 1925)<sup>8</sup> authorized the Postmaster General to award contracts for the carriage of mail to private carriers.<sup>9</sup> This marked the beginning of a viable private airline industry in the United States.<sup>10</sup>

The first five contracts were awarded to National Air Transport, Varney Lines, and Pacific Air Transport (all of which subsequently joined the United Air Lines system), Colonial Air Lines (later to become an important part of American Airlines), and Western Air Express

<sup>4</sup> A. LOWENFELD, AVIATION I-2 (1972).

<sup>5</sup> W. BOYNE, THE SMITHSONIAN BOOK OF FLIGHT 126 (1987).

<sup>6</sup> A. LOWENFELD, AVIATION I-2 (1972).

<sup>7</sup> TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION 21 (1991).

<sup>8</sup> 43 Stat. 805 (1925).

<sup>9</sup> See generally, R. BURKHARDT, THE CIVIL AERONAUTICS BOARD 4 (1974); S. RICHMOND, REGULATION AND COMPETITION IN AIR TRANSPORTATION 4 (1961); H. KNOWLTON, AIR TRANSPORTATION IN THE UNITED STATES 4 (1941); C. PUFFER, AIR TRANSPORTATION 2-3 (1941); L. KEYES, FEDERAL CONTROL OF ENTRY INTO AIR TRANSPORTATION 65-66 (1951); and P. DEMPSEY & W. THOMS, LAW & ECONOMIC REGULATION IN TRANSPORTATION 26 (1986).

<sup>10</sup> W. BOYNE, THE SMITHSONIAN BOOK OF FLIGHT 126 (1987).

(which would be merged into the TWA system).<sup>11</sup> The first air mail contracts established the route structure which would dominate air service for decades to come.

The Air Commerce Act of 1926<sup>12</sup> vested jurisdiction over safety and maintenance of airways, airports and air navigation facilities in the Secretary of Commerce.<sup>13</sup> In fact, federal regulation of aviation safety owes its genesis to the Air Commerce Act of 1926.<sup>14</sup> which established a special investigation division in the U.S. Department of Commerce and gave the Secretary of Commerce power to investigate and publicize air navigation accidents. With promulgation of the Civil Aeronautics Act of 1938,<sup>15</sup> Congress established the Civil Aeronautics Authority (subsequently renamed the Civil Aeronautics Board), and created therein an Air Safety Board with jurisdiction to investigate accidents, determine probable cause, issue reports, and recommend additional safety measures.<sup>16</sup> These powers were augmented by the Federal Aviation Act of 1958.

With the creation of the U.S. Department of Transportation in 1966, Congress established therein an independent National Transportation Safety Board [NTSB], giving it power to conduct investigations and hold hearings to determine "the cause or probable cause of transportation accidents and reporting the facts, conditions, and circumstances relating to such accidents."<sup>17</sup> The NTSB became truly independent and effectively autonomous from DOT with the Independent Safety Board Act of 1974.<sup>18</sup>

After Col. Lindbergh crossed the Atlantic in the Spirit of St. Louis in 1927, the industry enjoyed explosive growth. Even the stock of Seaboard Air Line, a southeastern

<sup>11</sup> A. LOWENFELD, AVIATION LAW I-2 (1972).

<sup>12</sup> 44 Stat. 568 (1926).

<sup>13</sup> P. DEMPSEY & W. THOMS, LAW & ECONOMIC REGULATION IN TRANSPORTATION 26-27 (1986).

<sup>14</sup> Pub. L. No. 254, 44 Stat. 568 (1926).

<sup>15</sup> Pub. L. No. 706, 52 Stat. 973 (1938).

<sup>16</sup> Clemen & Long, Representing Potential Litigants As Parties to NTSB Public Hearings: Some Problems In Search of Solutions, 56 J. AIR L. & COM. 969, 973 (1991).

<sup>17</sup> 49 U.S.C. app. sec. 1371-89.

<sup>18</sup> Id. sec. 1901-1907.

railroad, experienced an unprecedented increase because of speculators' belief that it was somehow connected to aviation.<sup>19</sup>

The McNary-Waters Act of 1930<sup>20</sup> established a formula for air mail payments based on the amount of mail transported.<sup>21</sup> But Postmaster General Brown wanted to create a few large competing transcontinental airlines.<sup>22</sup> Rather than determining the issuance of routes on the basis of competitive bidding, they were actually determined at secret meetings in May and June of 1929 -- later called "spoils conferences" -- of airline executives with Postmaster General Brown.<sup>23</sup> He also encouraged mergers and consolidations of smaller airlines into larger, consolidated companies.

As a consequence, Northwest Airways served the northern tier states, though it lacked a transcontinental route. United Air Lines (organized in December 1928) obtained control of National Air Transport, Boeing Air Transport, Varney Air Lines, and Pacific Air Transport, giving it a route system extending from New York to Chicago to San Francisco, and north and south along the Pacific coast.<sup>24</sup> Transcontinental and Western served the central United States, from New York to California via St. Louis and Kansas City. Eastern (then affiliated with Transcontinental) served the principal north-south routes, although United also had a route from Chicago to Texas.<sup>25</sup>

Congressional discontent with the administration of the McNary-Waters Act led to an investigation of these practices by a special Congressional committee chaired by Senator Hugo

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<sup>19</sup> A. LOWENFELD, AVIATION LAW I-3 (1972).

<sup>20</sup> 46 Stat. 258 (1930).

<sup>21</sup> P. DEMPSEY & W. THOMS, LAW & ECONOMIC REGULATION IN TRANSPORTATION 27 (1986).

<sup>22</sup> A. LOWENFELD, AVIATION LAW I-3, I-4 (1972).

<sup>23</sup> A. LOWENFELD, AVIATION LAW I-4, I-5 (1972).

<sup>24</sup> A. LOWENFELD, AVIATION LAW I-3, I-4 (1972).

<sup>25</sup> A. LOWENFELD, AVIATION LAW I-4 (1972).

Black.<sup>26</sup> The revelations of this investigation convinced President Franklin Roosevelt to terminate all existing air mail contracts on the grounds that there had been collusion between the airlines and the Post Office Department in route and rate establishment.<sup>27</sup> He directed the Army Air Corps to transport the mail. A series of tragic crashes, killing about a dozen Army pilots, proved that the Army was inadequately trained in air navigation, inclement weather and night flying, and that the private carriers were technologically proficient.<sup>28</sup>

Congress responded by passing the Airmail Act of 1934 (Black-McKellar Act),<sup>29</sup> which authorized the new Postmaster General to award mail contracts on the basis of competitive bidding (usually on an exclusive basis for a particular route).<sup>30</sup> The system was to be comprised of four transcontinental routes, and an eastern and western coastal route. The legislation prohibited financial interests by airlines in other aviation companies, holding companies, and interlocking directorates.<sup>31</sup> After the initial contract term, postal rates were set by the Interstate Commerce Commission [ICC].<sup>32</sup> Also beginning in 1934, federal funds became a primary source of airport funding.<sup>33</sup>

### C. GENESIS OF THE U.S. CIVIL AERONAUTICS BOARD

Its 1934 Act also established a Federal Aviation Commission [FAC] to study the entire field of aviation and report to Congress.<sup>34</sup> The FAC submitted 102 recommendations on January 30, 1935. It contended that the orderly development of air transportation required two fundamental ingredients. First, in the interest of safety, certain minimum standards of

<sup>26</sup> F. THAYER, JR., *AIR TRANSPORT POLICY AND NATIONAL SECURITY* 10 (1965). Roosevelt would subsequently appoint the Alabama Senator to fill the first vacancy arising on the U.S. Supreme Court during his presidency. Black served on Supreme Court from 1937 until 1971.

<sup>27</sup> P. DEMPSEY & W. THOMS, *LAW & ECONOMIC REGULATION IN TRANSPORTATION* 27 (1986).

<sup>28</sup> W. BOYNE, *THE SMITHSONIAN BOOK OF FLIGHT* 128 (1987); A. LOWENFELD, *AVIATION LAW* I-5 (1972).

<sup>29</sup> 48 Stat. 933 (1934).

<sup>30</sup> A. LOWENFELD, *AVIATION LAW* I-5, I-11 (1972).

<sup>31</sup> A. LOWENFELD, *AVIATION LAW* I-5 (1972).

<sup>32</sup> A. LOWENFELD, *AVIATION LAW* I-11 (1972).

<sup>33</sup> R. HARDAWAY, *AIRPORT REGULATION, LAW AND PUBLIC POLICY* 16 (1991).

<sup>34</sup> W. JONES, *REGULATED INDUSTRIES* 732 (1972).

equipment, operating methods and personnel qualifications should be maintained. Second, "there should be a check in development of any irresponsible, unfair or excessive competition such as has sometimes hampered the progress of other forms of transport."<sup>35</sup>

When the Great Depression broke, airlines were in their infancy. Congress was confronted with a national economic disaster, one which had hit the infrastructure industries particularly hard. Congress held hearings on the state of the airline industry, concluding that the economic condition of the airlines was unstable and that a continuation of its anemic condition could imperil its potential to satisfy national needs for growth and development. The legislative history of the Civil Aeronautics Act of 1938 is replete with concerns over excessive and destructive competition and the adverse effect that the economic crisis was having upon the industry and its ability to attract capital and maintain safe and adequate operations.<sup>36</sup> Demand for air services had softened significantly during the Great Depression, and carriers were spiraling downward into a sea of red ink. Without governmental protection, bankruptcies proliferated. Colonel Edgar S. Gorrell, president of the Air Transport Association, observed:

Since air transport was launched into meteoric growth, approximately \$120,000,000 of private capital has been devoted to it, but, of that sum, there remains today scarcely 50 percent. Since the beginning of air transport, a hundred scheduled lines have traversed the airways in a struggle to build this newest avenue of the sky. But today scarcely more than a score of those companies remain. The industry has been reduced to the very rock bottom of its financial resources. . . .

There are only two ways whereby the necessary capital can be provided to this industry. One is the way toward which the governments of foreign lands increasingly tend -- the way of mounting governmental subsidies, whereby public funds are poured without stint into air transport. The other way is the traditional American way, a way which invites the confidence of the investing public by providing a basic economic charter that promises the hope of stability and security, and orderly and intelligent growth under watchful governmental supervision.<sup>37</sup>

<sup>35</sup> Quoted in Dempsey, *The Rise and Fall of the Civil Aeronautics Board – Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 102 (1979).

<sup>36</sup> Dempsey, *The Rise and Fall of the Civil Aeronautics Board – Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 97 (1979).

<sup>37</sup> Quoted in Dempsey, *The Rise and Fall of the Civil Aeronautics Board – Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 97 n. 14 (1979).

Not only had private entrepreneurs invested considerable capital in the airline industry, but the federal and local governments had as well. That investment needed protection.<sup>38</sup> In order to avoid the deleterious impact of competition described with pejorative adjectives such as "intensive," "extreme," "destructive," "cutthroat", "wasteful," "excessive," "unbridled," and "unrestrained," and to avoid the economic "chaos" which had so plagued the rail and motor carrier industries, Congress established a regulatory structure similar to that which had been devised for an orderly development of those industries which had also been perceived to be "public utility" types of enterprises -- the railroads and motor carriers.<sup>39</sup>

Transportation was also viewed as different from other industries, with necessity characteristics making it in the nature of a "public utility", essential to the national economy and the national defense, therefore warranting protection of the "public interest" by government.<sup>40</sup> ICC Chairman Joseph Eastman noted, "important forms of public transportation must be regulated by the government. That has been accepted as a sound principle in this country and . . . in practically every country in the world. . . . Transportation is of such vital importance to the public welfare and the business is so affected with a public interest that some measure of government regulation is . . . necessary."<sup>41</sup>

The FAC recommended an independent agency be vested with jurisdiction to regulate airline entry, rates, service, consolidations and government subsidies. President Roosevelt preferred vesting these powers in the existing transportation regulatory agency, the ICC, which had been established in 1887 to regulate the railroads, and whose jurisdiction had been

<sup>38</sup> Dempsey, The Rise and Fall of the Civil Aeronautics Board -- Opening Wide the Floodgates of Entry, 11 TRANSP. L.J. 91, 102 (1979).

<sup>39</sup> Dempsey, The Rise and Fall of the Civil Aeronautics Board -- Opening Wide the Floodgates of Entry, 11 TRANSP. L.J. 91, 95-97 (1979).

<sup>40</sup> Dempsey, The Rise and Fall of the Civil Aeronautics Board -- Opening Wide the Floodgates of Entry, 11 TRANSP. L.J. 91, 96 n. 11 (1979).

<sup>41</sup> Quoted in Dempsey, The Rise and Fall of the Civil Aeronautics Board -- Opening Wide the Floodgates of Entry, 11 TRANSP. L.J. 91, 100 (1979).

expanded in 1935 to regulate the motor carriers and busses.<sup>42</sup> But the industry feared that the ICC would protect the interests of the railroads, which were the dominant passenger carriers of the day, and sought creation of their own aviation regulatory agency.

Three years after motor carriers were brought under the regulatory umbrella, Congress added airlines to the regulatory scheme, promulgating the Civil Aeronautics Act of 1938. In so doing, Congress created a new regulatory body to regulate this industry, the Civil Aeronautics Board [CAB], folding into it the existing Bureau of Air Commerce and the Bureau of Air Mail.<sup>43</sup> Like so many agencies created to engage in economic regulation, the CAB was modeled after its older sibling, the ICC.

The agency was a relative small institution by Washington standards, comprised of five members (no more than a simple majority of whom could be members of a single political party) appointed by the President with the advice and consent of the Senate, for staggered terms of office. It was given jurisdiction over three major aspects of airline operations: (1) entry (where a carrier could fly), (2) rates (what it could charge), and (3) antitrust and business practices. Additional powers conferred over such things as subsidies, consumer protection and, initially, the establishment and maintenance of airports and airway navigational aids.<sup>44</sup> But there were many significant aspects of airline operations over which it had no jurisdiction, including scheduling frequency, type of aircraft, or level of service.

The governing legislation encouraged the CAB to take several goals into account:

- (a) The encouragement and development of an air-transportation system properly adapted to the present and future needs of the foreign and domestic commerce of the United States, of the Postal Service, and of the national defense;

<sup>42</sup> W. JONES, REGULATED INDUSTRIES 732 (1972). P. DEMPSEY, THE SOCIAL AND ECONOMIC CONSEQUENCES OF DEREGULATION 9-14 (1989).

<sup>43</sup> The agency was initially named the Civil Aeronautics Authority. R. HARDAWAY, AIRPORT REGULATION, LAW AND PUBLIC POLICY 13 (1991).

<sup>44</sup> R. HARDAWAY, AIRPORT REGULATION, LAW AND PUBLIC POLICY 13 (1991).

- (b) The regulation of air transportation in such manner as to . . . assure the highest degree of safety in, and foster sound economic conditions in, such transportation . . . ;
- (c) The promotion of adequate, economical, and efficient service by air carriers at reasonable charges, without unjust discriminations, undue preferences or advantages, or unfair or destructive competitive practices; [and]
- (d) Competition to the extent necessary to assure the sound development of [the] air-transportation system . . . .<sup>45</sup>

#### D. REGULATION BY THE U.S. CIVIL AERONAUTICS BOARD

The CAB began by "grandfathering" in the existing airlines, or stated differently, issuing certificates of public convenience and necessity authorizing operations commensurate with the incumbents' existing operations (most of which were coterminous with their outstanding air mail contracts). In its first full year of operation, the CAB issued certificates of public convenience and necessity to 16 carriers:<sup>46</sup>

American  
 Braniff  
 Chicago & Southern (subsequently merged with Delta)  
 Colonial (subsequently merged with Eastern)  
 Continental  
 Delta  
 Eastern  
 Inland (subsequently merged with Eastern)  
 Mid-Continent (subsequently merged with Braniff)  
 National  
 Northeast  
 Northwest  
 Penn Central (name changed to Capital; merged with United)  
 Transcontinental and Western (name changed to Trans World Airlines)  
 United  
 Western

The federal regulatory regime, coupled with subsidies, brought stability to this important industry which had been so plagued by economic losses. But soon America entered World War II, and much of her civilian fleet was dedicated to military service.

<sup>45</sup> Federal Aviation Act of 1958, section 102.

<sup>46</sup> Callison, Airline Deregulation – A Hoax?, 41 J. AIR L. & COM. 747, 758 (1975). Many, of course, had disappeared or merged with surviving airlines because of an inability to sustain profitability. *Id.*

After the War, the CAB began to authorize "local service airlines" to provide feeder service to the "trunks" (grandfathered long-haul carriers) at regional gateways. Eventually, these local service carriers would grow to become regional airlines, with CAB authorization of their entry into denser and more lengthy routes beginning in the 1960s, competing with the trunk airlines.<sup>47</sup> By 1972, there were nine such carriers: Allegheny, Air West, Hughes, Frontier, North Central, Ozark, Piedmont, Texas International and Southern.<sup>48</sup>

Several thousand air taxis (originally termed "small irregular carriers") were also exempted by the CAB.<sup>49</sup> Commuter airlines (which flew aircraft seating no more than 19 passengers, later 60 passengers) were exempted.<sup>50</sup> This expanded service geographically and added a new group of airlines to the system. Between 1939 and 1975, the Civil Aeronautics Board certificated some 86 new airlines to compete with the 16 original carriers, and exempted thousands more from the certification requirements.<sup>51</sup> In addition, several intrastate airlines existed exempt from CAB requirements, including Southwest, Pacific Southwest, Air California and Air Florida.

In the 1950s, new generations of turboprop, then jet, aircraft spurred efficiency, productivity and speed, thereby reducing prices to consumers, while enhancing the margin of safety. Military research and development was a catalyst for technological development, for the World Wars had exhibited their proficiency at delivering bombs and soldiers. Each

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<sup>47</sup> TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION 26 (1991).

<sup>48</sup> TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION 27 (1991); A. LOWENFELD, AVIATION LAW I-17 (1972).

<sup>49</sup> By 1971, more than 3,500 air taxis served the United States. A. LOWENFELD, AVIATION LAW I-17 (1972).

<sup>50</sup> TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION 27 (1991).

<sup>51</sup> Callison, Airline Deregulation – A Hoax?, 41 J. AIR L. & COM. 747, 758 (1975). These 86 include U.S. firms given scheduled or supplemental authority to enter domestic, territorial and international markets. *Id.* n. 36.

generation of aircraft was superior to its predecessor in its abilities and its economics. In the 1960s, airlines became even faster and more economical.

The Civil Aeronautics Act was recodified and restructured by the Federal Aviation Act of 1958,<sup>52</sup> which spun off the navigation and safety responsibilities of the CAB into the newly created Federal Aviation Administration [FAA], originally a subsidiary of the U.S. Department of Commerce, and with the creation of the U.S. Department of Transportation [DOT] in 1966, a subsidiary of it.<sup>53</sup> The accident investigation and recommendation responsibilities of the CAB was transferred to the FAA initially, and was redelegated to the National Transportation Safety Board, made independent in 1974.<sup>54</sup> The CAB retained its jurisdiction over economic regulation of the nation's airlines, and was split off from the Commerce Department.<sup>55</sup>

Under economic regulation, America enjoyed the world's finest system of air transport, one envied by every other nation. The time and space continuum, and indeed, the planet, was shrinking. Service and safety were improving. When adjusted for inflation, prices were falling.

By the early 1970s, the industry was in a state of crisis. Excessive investment in wide-bodied aircraft (B-747s, DC-10s and L-1011s) had created excessive fleet capacity. That was coupled with an economic recession that suppressed passenger demand, as well as a fuel crisis stimulated by the Arab Oil Embargo of 1973. These events converged to create severe financial turbulence for the industry. The CAB believed that only a stiff dose of regulatory medicine would save the industry from disintegration.

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52 Pub. L. No. 85-625, 72 Stat. 568 (1958).

53 See A. LOWENFELD, AVIATION LAW I-15 (1972).

54 R. HARDAWAY, AIRPORT REGULATION, LAW AND PUBLIC POLICY 19, 21 (1991).

55 R. HARDAWAY, AIRPORT REGULATION, LAW AND PUBLIC POLICY 18 (1991).

In the early 1970s, the CAB took a number of steps to shore up the economic health of the airlines and avert catastrophe. First, the CAB implicitly entered a "route moratorium", during which not a single new route application was granted.<sup>56</sup> Second, the CAB allowed a number of major carriers to enter into capacity limitation agreements whereby the number of aircraft flown in major markets was reduced.<sup>57</sup> Third, the major international carriers, Pan Am and TWA, were allowed to swap routes, with TWA exiting the transpacific market, and Pan Am ceding southern Europe.<sup>58</sup> Finally, the CAB imposed rigid pricing regulation.

Thus, the pendulum was pulled sharply toward greater governmental involvement in the airline market. This would be perceived as an anti-consumer movement and opposed by the antitrusts. Sir Isaac Newton noted that for every action, there is an equal and opposite reaction. The pendulum of public policy, having been pulled so sharply toward the regulatory end of the spectrum, would soon come roaring back in the other direction.

#### E. THE POLITICS OF DEREGULATION

Let us step aside for a moment and point out that regulatory reform and deregulation are not the same thing, although the political movement for the former probably served as a catalyst for the latter. But regulatory reform, as originally conceived, consisted of a modest political agenda for improvement of the regulatory process. There were valid criticisms of government which demanded relief.

It was argued that government had become bloated, fat and lazy. Agencies were headed by political cronies rather than professional managers. Lethargy snuffed out innovation. The time and resources expended in complying with the regulatory labyrinth were

<sup>56</sup> Dempsey, *The Rise and Fall of the Civil Aeronautics Board – Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 115 (1979).

<sup>57</sup> Dempsey, *The Rise and Fall of the Civil Aeronautics Board – Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 117-18 (1979).

<sup>58</sup> See Dempsey, *The International Rate and Route Revolution in North Atlantic Passenger Transportation*, 17 COLUM. J. TRANSNAT'L L. 393 (1978).

excessive, as were the costs to taxpayers.<sup>59</sup> The agencies had allegedly been "captured" by the industries they regulated.<sup>60</sup> The regulatory reform movement, on the whole, seemed to appreciate the important public benefits that government was performing, but advanced a belief that the governmental function could be performed better, more expeditiously and economically. The regulatory reform movement focused largely on means. It called for greater regulatory flexibility to allow the industry to respond to market forces.

In contrast, the deregulation movement focused largely on ends. Deregulators wanted the very heart of the regulatory function amputated from the body politic, and free-market economists provided the intellectual cannon fodder, insisting that airlines were not public utilities, as they had been commonly perceived.<sup>61</sup>

The generation of Americans who grew up during the Great Depression and World War II, saw government as an essential companion -- a mechanism for achieving greater social good, protecting the country from threats without and within. For most Americans, the Depression shattered confidence in the theory of *laissez faire*. But the generation which grew up in the 1960s and 1970s grew up cynical, perceiving government to be a malignant sore. Those on the left abhorred Watergate and the war in Vietnam. Those on the right were offended by the Great Society and high taxes. Both converged on a common path that viewed government with some hostility. That provided the foundation for a bipartisan political movement supporting radically less government.<sup>62</sup>

<sup>59</sup> Dempsey, *Market Failure and Regulatory Failure As Catalysts for Political Change: The Choice Between Imperfect Regulation and Imperfect Competition*, 46 WASH. & LEE L. REV. 1, 26 (1989).

<sup>60</sup> *Id.* at 27.

<sup>61</sup> See R. CAVES, *AIR TRANSPORT AND ITS REGULATORS: AN INDUSTRY STUDY* (1962); G. DOUGLAS & J. MILLER III, *ECONOMIC REGULATION OF DOMESTIC AIR TRANSPORT: THEORY AND POLICY* (1974).

The Ford Foundation plopped \$1.8 million on the Brookings Institution between 1967 and 1975 to study economic regulation, and virtually all of the free-market literature which emanated from it found cause for deregulation. After the Ford money dried up, the emerging right-wing Washington think tanks picked up the gauntlet, including the American Enterprise Institute. M. DERTHICK & P. QUIRK, *THE POLITICS OF DEREGULATION* 36-37 (1985).

<sup>62</sup> P. DEMPSEY, *THE SOCIAL AND ECONOMIC CONSEQUENCES OF DEREGULATION* xv (1989).

In the 1960s and 1970s, a number of economists also published literature critical of economic regulation. They criticized the CAB as being captured by the industry it regulated. Said George Stigler, "every industry or occupation that has enough political power to utilize the state will seek to control entry."<sup>63</sup> They argued that regulation had made air transport more expensive than it need be, and that the level of service, although exemplary, was excessive.<sup>64</sup> Principal among their criticisms was that pricing and entry restrictions gave consumers excessive service and insufficient pricing competition, inflated airline costs, and thereby made the industry's profits unsatisfactory.<sup>65</sup> Deregulation would give consumers the range of price and service options they preferred, casting dollar votes of approval to firms which satiated their wants, as Adam Smith's invisible hand did its work. The market would define not only the dividing lines between price and service, but also how many and which airlines would serve individual city-pair markets.<sup>66</sup>

But the industry was hardly devoid of competition. By the early 1970s, nearly 80% of the nation's scheduled passenger traffic was already competitively served, and in many markets, multiple carriers had been certificated.<sup>67</sup> Although the big four airlines (i.e., United, American, TWA and Eastern) controlled 82% of the market in 1938, their share declined to 68% by 1950, 66% in 1960, and 62% in 1970.<sup>68</sup> By 1978, the market share of

<sup>63</sup> Stigler, The Theory of Economic Regulation 2 BELL J. ECON. & MGT. SCI. 6 (1971). See R. HARDAWAY, AIRPORT REGULATION, LAW AND PUBLIC POLICY 22 (1991).

<sup>64</sup> See Hardaway, Transportation Deregulation (1976-1984): Turning the Tide, 14 TRANSP. L.J. 101, 136 (1984); Dempsey, The Rise and Fall of the Civil Aeronautics Board: Opening Wide the Floodgates of Entry, 11 TRANSP. L.J. 91, 119 (1979).

<sup>65</sup> As CAB John Robson observed, "Only three times in the past 26 years, and never in the past decade, has the industry earned the . . . allowable return on investment." TRAFFIC WORLD (July 18, 1977), at 14. See Hardaway, Transportation Deregulation (1976-1984): Turning the Tide, 14 TRANSP. L.J. 101, 137 (1984); R. HARDAWAY, AIRPORT REGULATION, LAW AND PUBLIC POLICY 24 (1991); Snow, The Problem of Airline Regulation and the Ford Administration Proposal for Reform, REGULATION OF PASSENGER FARES AND COMPETITION AMONG AIRLINES 3 (P. MacAvoy & J. Snow eds. 1977); S. BREYER, REGULATION AND ITS REFORM 200 (1982).

<sup>66</sup> See Dempsey, The Rise and Fall of the Civil Aeronautics Board: Opening Wide the Floodgates of Entry, 11 TRANSP. L.J. 91, 122 (1979).

<sup>67</sup> Callison, Airline Deregulation - Only Partially a Hoax: The Current Status of the Airline Deregulation Movement, 45 J. AIR L. & COM. 961, 967 (1980).

<sup>68</sup> See A. LOWENFELD, AVIATION LAW I-21 (1972).

the top four had fallen to 59%.<sup>69</sup> Although pricing competition was somewhat constrained, airlines were free to compete in terms of schedules, equipment, capacity and facilities in response to consumer choices.

On Capitol Hill, the opening salvo was fired by Teddy Kennedy in hearings he conducted as Chairman of the Senate Judiciary Subcommittee on Administrative Practice and Procedure.<sup>70</sup> These hearings served as the political genesis of Congressional reform, jumping the gun on bills pending before the Senate Commerce Committee, the committee which actually had appropriate subject matter jurisdiction.<sup>71</sup> Kennedy began the hearings by saying, "Regulators all to often encourage or approve unreasonably high prices, inadequate service, and anticompetitive behavior. The cost of this regulation is always passed on to the consumer. And that cost is astronomical."<sup>72</sup>

After extensive hearings in 1974 and 1975, the Kennedy staff released a comprehensive report on the Subcommittee's behalf. The Kennedy Report concluded that deregulation would allow pricing flexibility which would stimulate new innovative service offerings, increase industry health, allow passengers the range of price and service options dictated by consumer demand, enhance carrier productivity and efficiency, and result in a superior allocation of

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<sup>69</sup> It would fall to 56% by 1983. Hardaway, Transportation Deregulation (1976-1984): Turning the Tide, 14 TRANSP. L.J. 101, 143 (1984) [citation omitted].

<sup>70</sup> Kennedy had been persuaded by subcommittee counsel Stephen Breyer that airline regulation was ripe for attack on behalf of consumers. M. DERTHICK & P. QUIRK, *supra* at 40. Breyer had previously been a Harvard Law Professor, and Brookings had published his book calling for natural gas deregulation. S. BREYER & P. MACAVOY, *ENERGY REGULATION BY THE FEDERAL POWER COMMISSION* (1974). Breyer would go on to become a federal judge; but for the moment, airline deregulation was his crusade, and the Civil Aeronautics Board was his enemy. Jurisdictionally, it was an odd thing for a Judiciary subcommittee to take up airlines or their regulation, for there was an aviation subcommittee already established under the Senate Commerce Committee chaired by Howard Cannon. Nevertheless, Kennedy charged ahead.

<sup>71</sup> Callison, Airline Deregulation -- Only Partially a Hoax: The Current Status of the Airline Deregulation Movement, 45 J. AIR L. & COM. 961, 963 n. 4 (1980). Senator Howard Cannon, Chairman of the Senate Commerce Committee, introduced a number of bills considered in committee beginning in 1976. *Id.*

<sup>72</sup> M. DERTHICK & P. QUIRK, *supra* at 41.

society's resources.<sup>73</sup> Regulated prices were estimated to be some 40% to 100% higher than they should be.<sup>74</sup> Deregulation, it was asserted, should drive prices down to costs.<sup>75</sup>

Many carriers and observers argued that the net result of deregulation would be deleterious to the industry in the short term, and in the long run injure the public it serves.

The Kennedy Subcommittee's disagreed:

The major arguments against allowing freer entry and greater price competition rests upon the fear of : 1) predatory pricing; 2) destructive competition; 3) monopolization; 4) reduced service to small communisms [sic]; 5) destruction of the existing air service network; 6) reduced safety standards; and 7) greater financing difficulties. The subcommittee examined each of these claims.

In the subcommittee's view there is no substantial historical, empirical, or logical reason for believing that increased reliance upon competition would lead to predatory pricing, destructive competition, or risk of monopolization.<sup>76</sup>

With Richard Nixon's resignation in 1974, Gerald Ford became President. After pardoning Nixon, Ford's immediate domestic problem was inflation. He believed that government was a major contributor to inflation.<sup>77</sup> Ford embraced deregulation in his Presidential campaign:

By the spring of 1975, Ford was speaking of regulatory reform as if it were an end in itself, not just one element in an anti-inflation program, and he was rationalizing it on grounds that mixed popular culture, individual psychology and economics . . . .

<sup>73</sup> Dempsey, The Rise and Fall of the Civil Aeronautics Board -- Opening Wide the Floodgates of Entry, 11 TRANSP. L.J. 91, 114-18 (1979).

<sup>74</sup> CIVIL AERONAUTICS BOARD PRACTICES AND PROCEDURES, REPORT OF THE SUBCOMM. ON ADMINISTRATIVE PRACTICE AND PROCEDURE OF THE SENATE JUDICIARY COMM. 94th Cong., 1st Sess. 189 (1975). Another study asserted that prices were between 45% and 84% higher than they would be without regulation. Keeler, Airline Regulation and Market Performance, 3 BELL J. ECON. & MGT. 399, 421 (1972).

<sup>75</sup> Hardaway, Transportation Deregulation (1976-1984): Turning the Tide, 14 TRANSP. L.J. 101, 145 (1984).

<sup>76</sup> CIVIL AERONAUTICS BOARD PRACTICES AND PROCEDURES, REPORT OF THE SUBCOMM. ON ADMINISTRATIVE PRACTICE AND PROCEDURE OF THE SENATE JUDICIARY COMM. 94th Cong., 1st Sess. 4 (1975).

<sup>77</sup> M. DERTHICK & P. QUIRK, *supra* at 45.

[W]hereas Senator Kennedy had hewed consistently to a proconsumer theme, Ford's criticisms of regulation were variously addressed to consumer interests, business interests, the traditional American attachment to free enterprise, and popular hostility to big government. Mass distrust of government was growing, and so was resentment of the costs of supporting it and bearing its intrusion on private activity. A policy stance that promised to reduce government activity therefore had some potential for mass appeal (and some potential utility for a president who would soon be asking the national electorate to return him to office).<sup>78</sup>

#### F. THE AIRLINE DEREGULATION ACT OF 1978

With the inauguration of Jimmy Carter as President in 1976, the movement had a firm disciple in the White House. Convinced by his staff that he could exploit the deregulation movement and make a "quick hit" politically, Carter embraced the deregulation movement even more strongly than his predecessor.<sup>79</sup>

Carter became a true believer in the deregulation of airlines, trucking and railroads. It was he who championed, then signed into law, the Air Cargo Deregulation Act of 1977, the Airline Deregulation Act of 1978, the Staggers Rail Act of 1980, and the Motor Carrier Act of 1980. It was he who appointed individuals strongly wedded to deregulation to the regulatory agencies -- Alfred Kahn, Elizabeth Bailey, and Marvin Cohen to the CAB, and Darius Gaskins, Marcus Alexis and Tad Trantum to the ICC -- known affectionately in each agency as the Three Marketeers.<sup>80</sup>

In 1977, Jimmy Carter tapped economist Alfred Kahn to serve as Chairman of the CAB. As Chairman of the New York Public Utilities Commission, Kahn had advocated deregulation before the Kennedy Subcommittee.<sup>81</sup>

<sup>78</sup> M. DERTHICK & P. QUIRK, *supra* at 46-47.

<sup>79</sup> Callison, *Airline Deregulation -- Only Partially a Hoax: The Current Status of the Airline Deregulation Movement*, 45 J. AIR L. & COM. 961, 963 n. 4 (1980).

<sup>80</sup> See Dempsey, *The Interstate Commerce Commission: Disintegration of An American Legal Institution*, 34 AM. U. L. REV. 1 (1984).

<sup>81</sup> Kahn had previously, and would subsequently, serve as a free-market economics professor at Cornell. He would subsequently serve as a member of the board of New York Air, a subsidiary of Frank Lorenzo's Texas Air.

Kahn criticized traditional CAB regulation as having "(a) caused air fares to be considerably higher than they otherwise would be; (b) resulted in a serious misallocation of resources; (c) encouraged carrier inefficiency; (d) denied consumers the range of price/service options they would prefer, and; (e) created a chronic tendency toward excess capacity in the industry."<sup>82</sup>

Being an economist, he was free of the fidelity to law held by his predecessor at the CAB, John Robson. Robson was Gerald Ford's CAB Chairman, and a lawyer. Being a lawyer, Robson felt constricted by his oath of office to roam only within the perimeters of the governing legislation, the Federal Aviation Act of 1958. The legislation would allow modest liberalizations, but no more. As CAB Chairman, Kahn would proceed a great deal farther down the path of laissez faire than could Robson.<sup>83</sup>

As CAB Chairman, Kahn implemented a number of revolutionary deregulatory initiatives which liberalized entry and pricing.<sup>84</sup> Soon carriers were authorized to enter new markets, and offer consumers significant discounts over previous levels. The immediate results appeared overwhelmingly successful, with carriers in the late 1970s stimulating new demand by offering low fares, filling capacity, and enjoying robust profits.

This was the first taste of regulatory reform for the airline industry, and it appeared to be an immediate success. The rigid regulatory structure of the preceding decade had so

<sup>82</sup> Quoted in P. DEMPSEY, LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION 24 (1987).

<sup>83</sup> See Dempsey, *The Rise and Fall of the Civil Aeronautics Board — Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 118-19 (1979). Kahn loved to hold court. He used the opportunities of the Sunshine Act to hold most CAB meetings public, and the media loved his performance.

Kahn made sessions at the CAB more than the public meetings that by law they now must be; he consciously made them public performances, a form of theater, at which the audience — the general press, the trade press, the industry, the CAB staff — watched him pursue with his pedagogue's passion for reasoned inquiry the question of why airline regulation was as it was and why it could not be done differently.

M. DERTHICK & P. QUIRK, *supra* at 87.

<sup>84</sup> See e.g., *Oakland Service Case*, CAB Order 78-4-121 (1978), CAB Order 78-9-96 (1978); *Improved Authority to Wichita Case*, CAB Order 78-3-78 (1978).

shackled carriers that they were unable to tap the elasticities of demand to fill seats that otherwise would fly empty. As a consequence, capacity was not being filled, and airline profitability was weak.

Regulatory reform would change all that. By lowering prices, airlines were able to lure discretionary (vacation) travelers to fill seats which had theretofore flown empty. Consumers enjoyed a bonanza of lower fares. Airlines were able to fill empty capacity, and with an upturn in the economy, enjoyed higher profits.<sup>85</sup> Regulatory reform appeared to be a win-win proposition. Politicians from both parties and from a wide spectrum of ideologies jumped on the deregulation bandwagon. If some regulatory reform was good, it was thought, then more will be better.

Kahn was quick witted, articulate, and could charm an overcoat off a freezing man. Working with the White House, Kahn put his charismatic personality solidly behind the legislative effort for reform. Kahn found allies in Federal Express and United Airlines, the latter the largest airline in the free world.

Federal Express had been held back for years by the CAB's desire to protect the passenger carriers, which enjoyed incremental profits on cargo carried in the belly. Operating largely under exemptions for small aircraft, Federal had been prohibited from flying the larger aircraft which would reduce unit costs. United, the largest airline before and during the four decades of regulation, but whose market share had fallen under regulation (from 22.9% in 1938 to 22.0% in 1976),<sup>86</sup> felt that the CAB nurtured the health and well-being of the smaller

<sup>85</sup> "These CAB actions happened to coincide with an upturn in the economy and the consequent return of prosperous times to the airline industry — a rapid traffic growth and increasing profits. This quasi-deregulation by the CAB was given credit by many for this airline prosperity. There is good reason to question the causal connection between these CAB policies and the favorable economic results which the industry experienced at that time, but the conditions helped Senator Cannon move a strong deregulation bill through the Senate in early 1978." Callison, *Airline Deregulation — Only Partially a Hoax: The Current Status of the Airline Deregulation Movement*, 45 J. AIR L. & COM. 961, 964 n. 4 (1980).

<sup>86</sup> Dempsey, *The Rise and Fall of the Civil Aeronautics Board — Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 115 (1979).

airlines to its detriment. The CAB had effectively stopped granting new routes to the largest trunk airlines by the 1970s.<sup>87</sup> United perceived itself big enough to grow and prosper in a deregulated regime.

Congress responded by promulgating the Air Cargo Deregulation Act of 1977<sup>88</sup> (known in Washington as the Federal Express Act, both for the speed by which it flew through Capitol Hill and the identity of its principal sponsor) and, in the closing hours of the 95th Congress, the Airline Deregulation of 1978.<sup>89</sup>

The Air Cargo Deregulation Act included a rather clever provision allowing established air cargo companies a one year moratorium (from November 1977 to November 1978) during which they were free to enter any domestic markets of their choice; new entrants would be free to enter only after that period. Thus, established carriers like Federal Express expanded during that year to dominate the industry. Although "fitness" remains a requirement of entry, tariff filing requirements were eliminated in 1979.<sup>90</sup>

The Airline Deregulation Act of 1978 called for a gradual transition from regulation to competition, eliminating most entry controls (except "fitness") on December 31, 1981, and domestic rate regulation on December 31, 1982.<sup>91</sup> The Act also included an unprecedented provision mandating the extermination (a/k/a "sunset") of the U.S. Civil Aeronautics Board on December 31, 1984, -- the first major federal agency to be obliterated in the nation's history.<sup>92</sup>

<sup>87</sup> TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION 50 (1991).

<sup>88</sup> Pub. L. 95-163; 91 Stat. 1285 (Nov. 9, 1977).

<sup>89</sup> Pub. L. 95-504; 92 Stat. 1705 (Oct. 24, 1978).

<sup>90</sup> See generally, R. SAMPSON, M. FARRIS & D. SHROCK, DOMESTIC TRANSPORTATION 394 (1990).

<sup>91</sup> P. DEMPSEY & W. THOMS, LAW & ECONOMIC REGULATION IN TRANSPORTATION 29 (1986).

<sup>92</sup> This was the work of Rep. Elliot Levitas of Georgia, described as "the staunchest advocate of real deregulation on either side of Congress." Callison, Airline Deregulation -- Only Partially a Hoax: The Current Status of the Airline Deregulation Movement, 45 J. AIR L. & COM. 961, 964 n. 4 (1980).

The legislation received overwhelming bipartisan support, which was surprising in that the bills were advanced from the top down; they had no widespread grass-roots support among the people.<sup>93</sup> Indeed, public opinion polls revealed that in 1978 Americans ranked airlines among the very top of all industries in terms of customer satisfaction and confidence.<sup>94</sup> One industry executive who supported immediate deregulation conceded that four decades of regulation ". . . did produce the world's foremost air transportation system, with more service in more markets by more carriers with more competition with greater variety of lower rates and fares than existed anywhere else on earth."<sup>95</sup>

The predictions as to what deregulation would bring were quite optimistic, in spite of strong misgivings by most industry executives. CAB Chairman Alfred Kahn characterized the opposition as follows: "The most general fear about [deregulation] is that when the CAB withdraws its protective hand from the doorknob, the door will open to destructive competition -- to wasteful entry and cut-throat pricing -- that will depress profits, render the industry unable to raise capital, and so cause a deterioration in the service it provides -- on the whole, it must be admitted good service."<sup>96</sup> Kahn saw the fear as unrealistic.

What about the prediction by many industry experts that deregulation would depress industry profits, discourage investment and the introduction of more technologically sophisticated aircraft, and lead to a deterioration of service, causing the industry ultimately to gel into a national oligopoly, or in many markets, a monopoly?<sup>97</sup> Deregulation's proponents

<sup>93</sup> "The absence of a significant public role throughout this period is a most interesting facet of the airline deregulation movement. The impetus for change came almost entirely from the academics and politicians; the public never did call for deregulation of the airline industry." Callison, *Airline Deregulation -- Only Partially a Hoax: The Current Status of the Airline Deregulation Movement*, 45 J. AIR L. & COM. 961, 964 n. 4 (1980).

<sup>94</sup> Callison, *Airline Deregulation -- Only Partially a Hoax: The Current Status of the Airline Deregulation Movement*, 45 J. AIR L. & COM. 961, 964 n. 4 (1980).

<sup>95</sup> Callison, *Airline Deregulation -- Only Partially a Hoax: The Current Status of the Airline Deregulation Movement*, 45 J. AIR L. & COM. 961, 968 (1980).

<sup>96</sup> A. Kahn, *Talk to the New York Society of Security Analysts* 14 (Feb. 2, 1978).

<sup>97</sup> Dempsey, *The Rise and Fall of the Civil Aeronautics Board -- Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 130-33 (1979).

saw destructive competition as limited to circumstances where "capital is long-lived and immobile, and through miscalculation competitors irretrievable commit too much to a particular market . . ."<sup>98</sup> a situation not thought to exist in the airline industry because of the mobility of its resources.<sup>99</sup> Concentration was also thought unlikely because: (1) barriers to entry were perceived low; (2) economies of scale were relatively insignificant; and (3) markets would be contestable -- the three legs of the theoretical stool.<sup>100</sup>

According to Alfred Kahn, "almost all of this industry's markets can support only a single carrier or a few: their natural structure, therefore, is monopolistic or oligopolistic. This kind of structure could still be conducive to highly effective competition if only the government would get out of the way; the ease of potential entry into those individual markets, and the constant threat of its materializing, could well suffice to prevent monopolistic exploitation."<sup>101</sup> Kahn and his free market brothers saw few economies of scale or economic barriers to entry in the airline industry.<sup>102</sup> The CAB staff noted, "There are no structural traits inherent in domestic air transportation which indicate superior performance by large-size firms; nor are there traits which would significantly inhibit the entry of new firms into the

<sup>98</sup> Oakland Service Case, CAB Order 78-3-78 (1978), at 26.

<sup>99</sup> Dempsey, *The Rise and Fall of the Civil Aeronautics Board — Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 130-31 (1979).

<sup>100</sup> Others disagreed, arguing that given the capital requirements of air transportation and the interrelationship of traffic flows which place a premium on the ability of a carrier to marshall traffic support from as many sources as possible, incumbent airlines could deter new entry by demonstrating they would respond sharply and swiftly to the inauguration of new service. Because potential entry could be deterred by potential response, the elimination of competition through the employment of predatory tactics would be economically rational. Dempsey, *The Rise and Fall of the Civil Aeronautics Board — Opening Wide the Floodgates of Entry*, 11 TRANSP. L.J. 91, 132 (1979).

<sup>101</sup> A. Kahn, *Talk to the New York Society of Security Analysts* 24 (Feb. 2, 1978).

<sup>102</sup> R. CAVES, *AIR TRANSPORT AND ITS REGULATORS* (1962); D. GILLEN, T. OUM & M. TRETHEWAY, *AIRLINE COSTS AND PERFORMANCE: IMPLICATIONS FOR PUBLIC AND INDUSTRY POLICIES* (1985). See TRANSPORTATION RESEARCH BOARD, *WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION* 25 (1991). Predictions that the industry would become more highly concentrated under deregulation " . . . rest on two false assumptions: 1) barriers to entry are relatively high, and 2) there are significant economies of scale and decreasing costs. Economic barriers to entry are relatively low in the airline industry. The most important barriers have been legal barriers enforced by the CAB. Economic barriers pale by comparison . . . Economies of scale are relatively low in the airline industry; in fact, there are significant diseconomies of scale." Hardaway, *Transportation Deregulation (1976-1984): Turning the Tide*, 14 TRANSP. L.J. 101, 141, 42 (1984) [citation omitted].

industry.<sup>103</sup> Deputy DOT Secretary John Snow agreed: "The evidence suggests very strongly that the optimal size of firms will be sufficiently small so that there will be room for a considerable number of competitive firms in the industry."<sup>104</sup> Hence entry, or the threat of potential entry, would keep monopolists from extracting monopoly profits.<sup>105</sup> This was the theory of contestable markets, upon which deregulation was largely premised.<sup>106</sup> Essentially, should a monopolist or oligopolist begin to earn supercompetitive profits, new entrants should be attracted like sharks to the smell of blood.

The absence of barriers to entry would also subdue incentives for larger airlines to engage in predatory pricing to drive their weaker or smaller rivals out. It was believed irrational for a carrier to engage in predatory pricing.<sup>107</sup>

Kahn was optimistic that the benefits of deregulation would be universally shared: "I am confident that . . . consumers will benefit; that the communities throughout the nation -- large and small -- which depend upon air transportation for their economic well being will benefit, and that the people most closely connected with the airlines -- their employees, their stockholders, their creditors -- will benefit as well."<sup>108</sup>

In the late 1970s, the immediate results of deregulation seemed quite positive, and created a general euphoria in Washington and in the media that Congress had chosen the right path. In the short term, air fares plummeted (a bonanza for consumers) while carrier profits soared as low fares led discretionary travelers to fill seats which otherwise might have flown

<sup>103</sup> STAFF OF THE CIVIL AERONAUTICS BOARD, REGULATORY REFORM 125 n.1 (1975).

<sup>104</sup> Snow, Aviation Regulation: a Time for Change, 41 J. AIR L. & COM. 640 (1975).

<sup>105</sup> Id. at 648. See A. Kahn, Talk to the New York Society of Security Analysts 26 (Feb. 2, 1978).

<sup>106</sup> See Bailey & Panzar, The Contestability of Airline Markets During the Transition to Deregulation, LAW & CONTEMP. PROBS. 125, 129 (1981); Bailey & Baumol, Deregulation and the Theory of Contestable Markets, 1 YALE J. REG. 111 (1984); W. BAUMOL, J. PANZAR & R.

<sup>107</sup> WILLIG, CONTESTABLE MARKETS AND THE THEORY OF INDUSTRY STRUCTURE (1982).

<sup>108</sup> S. BREYER, REGULATION AND ITS REFORM 30 (1982); Hardaway, Transportation Deregulation (1976-1984): Turning the Tide, 14 TRANSP. L.J. 101, 142 (1984) [citation omitted].

<sup>109</sup> Statement of Alfred E. Kahn Before the Aviation Subcommittee of the House Public Works and Transportation Committee on H.R. 11145, 8 (Mar. 6, 1978)

empty. But in the fourth quarter of 1978, long before the recession of the 1980s, carrier profits began to plummet into a sea of red ink; the airline industry suffered the worst losses in the history of domestic aviation.

#### G. IMPLEMENTATION OF DEREGULATION

As noted above, the Airline Deregulation Act of 1978 was intended to provide a gradual transition to deregulated domestic entry and rates, with entry regulation ending on January 1, 1982, and entry regulation ending January 1, 1983. But the CAB quickly dropped any notion of "gradual" deregulation under Chairman Marvin Cohen.<sup>109</sup> Implementation of the new policy was immediate and comprehensive.<sup>110</sup>

The Airline Deregulation Act also called for the "sunset" of the CAB in 1985, when its remaining responsibilities were transferred to the U.S. Department of Transportation.<sup>111</sup> Those primarily involved the regulation of international routes and rates, small community subsidies, and mergers. The latter was transferred to the U.S. Department of Justice in 1989, following serious public criticism of DOT's approval of each of the 21 merger proposals that had been submitted to it during its brief reign over the matter.<sup>112</sup>

#### H. CONSEQUENCES OF DEREGULATION

It is difficult to ascribe the contemporary condition of the industry to deregulation, for so many other factors influence its product and condition -- e.g., inflation or recession and their impact on passenger and cargo demand, airport infrastructure, and fuel costs. Nonetheless, widespread costs and benefits have been alleged.

<sup>109</sup> Kahn had left the CAB to become President Carter's "Inflation Czar", where he presided over the highest levels of inflation in peacetime history.

<sup>110</sup> See *Rise and Fall of the CAB*, *supra* note 55.

<sup>111</sup> Authority over antitrust was scheduled to vest in the Justice Department in 1985 under the terms of the Airline Deregulation Act of 1978. However, the CAB Sunset Act of 1984 gave it to the DOT. That lasted until 1989, when Congress took it from DOT and gave it to DOJ. *TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION* 30 (1991).

<sup>112</sup> Dempsey, *Antitrust Law and Policy in Transportation: Monopoly IS the Name of the Game*, 21 *GA. L. REV.* 505, 510-47, 588-99 (1987).

Perhaps the most consistent theme expressed by deregulation's proponents is that deregulation has caused a significant decline in fares. For example, Steven Morrison and Clifford Winston of the Brookings Institution maintain that price savings have resulted in consumer savings amounting to some \$6 billion a year.<sup>113</sup> About \$4 billion of that is attributed to business traveler time savings because of more frequencies.

This has been a matter of some controversy. Some maintain that the hub-and-spoke phenomenon has caused the air transport system to become decidedly slower because both of circuitous routings, congestion, and delays at hub airports necessitated by passenger transfers. Moreover, much of the pro-deregulation literature fails to mention the pre-deregulation trend of declining fares which preceded 1978.<sup>114</sup> In fact, except for a period of sharp fare declines from 1976 to 1979, fuel and inflation adjusted fares fell at a 30% faster rate in the decade preceding deregulation than in the decade subsequent to it.<sup>115</sup> Both sides tend to agree that pre-deregulation price declines were driven by productivity improvements resulting from technological breakthroughs of aircraft. Each generation of aircraft is more efficient in terms of fuel consumption and passenger cost. Deregulation proponents insist that most of the major technological breakthroughs occurred prior to deregulation, and attribute ticket price declines to deregulation itself.

Recent literature shows a decline in the rate of airline productivity growth after 1978.<sup>116</sup> Deregulation critics point out that the pre-deregulation trend of flying increasing numbers passengers nonstop in wide-bodied aircraft (Boeing 747s, McDonnell-Douglas DC-10s, and Lockheed L-1011s) was aborted with the development of hubs-and-spokes, which

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<sup>113</sup> S. MORRISON & C. WINSTON, THE ECONOMIC EFFECTS OF AIRLINE DEREGULATION (1986).

<sup>114</sup> See Brenner, Rejoinder to Comments By Alfred Kahn, 16 TRANSP. L.J. 253, 254 (1988).

<sup>115</sup> P. DEMPSEY, FLYING BLIND: THE FAILURE OF AIRLINE DEREGULATION 29-30 (1990).

<sup>116</sup> Brenner, Airline Deregulation - A Case Study in Public Policy Failure, 16 TRANSP. L.J. 179, 220 (1988). R. Gordon, Productivity in the Transportation Sector (unpublished monograph 1991).

require smaller planes with higher seat mile costs.<sup>117</sup> Hubbing also burns more fuel and consumes more labor and time.

Whatever the truth on whether deregulation has benefitted consumers, its impact on the industry itself has been profound. By 1992, the airline industry had suffered more than 150 bankruptcies, 50 mergers, and lost all the profit it had made since the Wright Brothers flight at Kitty Hawk, plus \$1.5 billion more. Alfred Kahn, on balance still a defender of deregulation, admits, "There is no denying that the profit record of the industry since 1978 has been dismal, that deregulation bears substantial responsibility, and that the proponents of deregulation did not anticipate such financial distress--either so intense or so long-continued."<sup>118</sup>

Since deregulation, national and regional concentration have reached unprecedented levels, although most city-pair markets were served by more carriers than before. One source describes five major issues of concern of airline deregulation:

- o The competitiveness of the industry (its effects on the fares and level of service provided to consumers today and the prospects of reduced competition from further industry concentration).
- o The long-term financial stability of the industry.
- o Possible discrimination against consumers of different types or in different parts of the country.
- o The safety provided to the public by airlines and the FAA, and

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<sup>117</sup> See Brenner, *Airline Deregulation - A Case Study in Public Policy Failure*, 16 TRANSP. L.J. 179, 217-18 (1988); Dempsey, *The Disintegration of the United States Airline Industry*, 20 TRANSP. L.J. 9, 23 (1991).

<sup>118</sup> Kahn, *Airline Deregulation - A Mixed Bag, But A Clear Success Nevertheless*, 16 TRANSP. L.J. 229, 248 (1988) [citations omitted].

o The ability of the federal government to respond to airport and airway capacity constraints.<sup>119</sup>

Because performance of the industry under deregulation has deviated significantly from the economic model of near perfect competition predicted, some of deregulation's early proponents have reevaluated their hypotheses. Michael Levine, among the most staunch early proponents of deregulation, and whose early literature on the subject found no economies of scale of significance in commercial aviation,<sup>120</sup> has more recently developed a theoretical justification for and found the existence of substantial economies of scale and scope in the industry.<sup>121</sup>

The early economics literature also emphasized the potential contestability of airline markets. Subsequent evaluation of commercial aviation finds little evidence of contestability.<sup>122</sup> As Charles Rule, Assistant Attorney General for Antitrust observed, "[M]ost airline markets do not appear to be contestable, if they ever were. . . . [D]ifficulties of entry, particularly on city-pairs involving hub cities, mean that hit-and-run entry is a theory that does not comport with current reality."<sup>123</sup>

One way of assessing deregulation is to ask what would have been different had the Civil Aeronautics Board [CAB] not been sunset. One might argue that with deregulation, we

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<sup>119</sup> TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION 43 (1991).

<sup>120</sup> Note, Is Regulation Necessary? California Air Transportation and National Regulatory Policy, 74 YALE L.J. 1416 (1965).

<sup>121</sup> Levine, Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy, 4 YALE J. REG. 393 (1987). TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION 25 (1991).

<sup>122</sup> E. BAILEY & D. KAPLAN, DEREGULATING THE AIRLINES (1985); Bailey & Williams, Sources of Economic Rent in the Deregulated Airline Industry, 31 J. L. & ECON. 173 (1988); Levine, Airline Competition in Deregulated Markets: Theory, Firm Strategy, and Public Policy, 4 YALE J. REG. 393, 405-25 (1987). TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION 25 (1991).

<sup>123</sup> C. Rule, Antitrust and Airline Mergers: A New Era 15, 18 (speech before the International Aviation Club, Washington, D.C., Mar. 7, 1989).

have replaced the five member CAB with the four or five top civil aeronautics executives [CAE].

1. Would prices have fallen? Adjusted for inflation, prices were falling steadily every decade preceding deregulation. As technological advances increased productivity, cost savings were passed through to consumers. Although prices fell dramatically in the 1977-79 period, adjusted for fuel costs and inflation they fell at a 30% slower rate in the decade following deregulation than in the decade preceding it.<sup>124</sup> Hubbing, the dominant megatrend on the deregulation landscape, caused a shift away from larger aircraft. Hubbing also increases fuel and labor costs. Hubbing likely would not have occurred under regulation. Productivity improvements would likely have driven prices downward.
2. Would the CAB have allowed the largest three airlines to dominate the three busiest airports in the nation? Never.
3. Would the CAB have given the largest airlines the lion's share of the scarce landing slots at the four slot constrained airports? No. Certainly, small airlines would have a significant presence under the CAB's tutelage.
4. Would the CAB have awarded the most important international routes to the three largest airlines? Absolutely not.
5. Would the CAB have allowed the corporate raiding of the 1980s to saddle the industry with enormous debt? The CAB would likely have scrutinized the leveraged buy-outs of Frank Lorenzo at Continental and Eastern, Carl Icahn at TWA and Alfred Checchi at Northwest carefully and concluded that they failed to satisfy the public interest standards of section 408 of the Federal Aviation Act and the fitness requirements of section 401.

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<sup>124</sup> P. DEMPSEY, FLYING BLIND: THE FAILURE OF AIRLINE DEREGULATION 27-35 (1990).

6. Would the industry be in such dire financial condition had the CAB been in business? Profits were hardly robust under the CAB's tutelage, but they turned sharply south after deregulation. The CAB would likely have used a variety of regulatory mechanisms to restore profitability, including prohibiting corporate raids, authorizing lucrative market opportunities to weaker carriers, and prohibiting predatory pricing. The only thing the Reagan/Bush DOT identified as a means of shoring up the financial condition of the disintegrating airlines is foreign ownership. Since most foreign airlines are governmentally owned or subsidized, this effectively means a government bail-out, with the novel twist that we are going to use the tax dollars of foreign citizens to rectify the mistakes of U.S. government policy, without ever having to admit that deregulation is a failure.

Another way to view the public interest in a market system is to defer to the system of private ownership by stockholders. These widely diversified companies are, after all, controlled by the public in the form of stockholders, are they not?

If stockholders controlled UAL, would it have paid its chief executive officer \$18 million in a year when it was losing three times as much? Would it have turned down a bid for \$240 a share (in April 1992, it was selling for almost half that)? If stockholders controlled Continental, would it have proposed to wipe out all the value of their stock in reorganization? Not.

### ***III. THE CONTEMPORARY AIRLINE INDUSTRY – FROM A TO Z***

#### **A. AIRCRAFT**

Aircraft is the single most important manufacturing export produced in the United States. The Congressional Research Service has estimated that for every dollar in aircraft exports, the U.S. economy increases by \$2.30; for every billion dollars in aircraft exports,

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U.S. employment grows by 35,000 jobs.<sup>125</sup> In 1990, U.S. manufacturers exported \$16.7 billion in aircraft, while the United States imported only \$737 million worth of planes.<sup>126</sup>

Boeing is the largest commercial aircraft manufacturer, accounting for 47% of the market in 1990, followed by Airbus with 35%, and McDonnell Douglas with 17%.<sup>127</sup> Lockheed exited the commercial aircraft injury in 1981, after losing \$2.5 billion making L-1011 TriStars.<sup>128</sup>

As 1991 drew to a close, the aircraft manufacturers had the following orders outstanding.

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AIRCRAFT ORDERED, DELIVERED, BACKLOGGED<sup>129</sup>  
(cumulative, as of December 31, 1991)

CARRIER/AIRCRAFT TYPE	ORDERS	DELIVERIES	BACKLOG
<b>AIRBUS INDUSTRIE</b>			
A300	457	364	93
A310	251	200	51
A320	661	251	410
A330	143	0	143
A340	115	0	115
<b>Total</b>	<b>1,767</b>	<b>815</b>	<b>952</b>
<b>BOEING</b>			
707	1,010	1,008	2
737	2,929	2,184	745
747	1,160	892	268
757	766	413	353
767	597	404	193
777	76	0	76
<b>Total</b>	<b>6,538</b>	<b>4,901</b>	<b>1,637</b>
<b>BRITISH AEROSPACE</b>			
BAe 146 RJ70/80	229	191	38
<b>CANADAIR</b>			
Regional Jet	38	0	38
Fokker 100	248	103	145

<sup>125</sup> Congressional Study Concludes Airbus Injuring Boeing, Douglas, AVIATION DAILY (Feb. 20, 1992), at 303, 304.

<sup>126</sup> Wartzman, Carey & Mark, A McDonnell Deal in Asia Would Jolt the Airliner Industry, Wall St. J. Nov. 15, 1991, at 1.

<sup>127</sup> Airbus Captures 35 Percent of Big Transport Market in 1990, AVIATION DAILY (Jan. 10, 1991), at 61.

<sup>128</sup> Will Boeing's Tail Turn White?, ECONOMIST (Apr. 13, 1991, at 61.

<sup>129</sup> Jet Orders, Cancellations, Net Orders and Delivery Summary, AVIATION DAILY (Feb. 6, 1992), at 227.

MCDONNELL DOUGLAS			
MD-80	1,137	964	173
MD-90	61	0	61
MD-11	172	34	138
Total	1,370	998	372
GRAND TOTAL	10,190	7,008	3,182

Airbus is owned and subsidized by several European governments. Airbus' growth has been robust. Its market share climbed from 16% in 1988 to 22% in 1989.<sup>130</sup> U.S. aircraft manufacturers have complained about the \$10 billion to \$20 billion in subsidies given Airbus by several European governments.<sup>131</sup> The United States claims that subsidies to Airbus total more than \$13.5 billion, or \$19.4 billion if interest costs are added.<sup>132</sup> Alleged dumping of aircraft has led Commerce Department officials to suggest that the U.S. might escalate its dispute under the General Agreement on Trade and Tariffs, impose duties on other European products, or take other anti-dumping measures.<sup>133</sup>

McDonnell Douglas enjoyed an average of 23% of the commercial aircraft market over the past half century. But by 1991, McDonnell Douglas' market share had fallen to 17%.<sup>134</sup> In 1991, financially troubled McDonnell Douglas Corp. announced its intention to sell 40% of its commercial manufacturing operations to Taiwan Aerospace Corp. for about \$2 billion.<sup>135</sup> McDonnell needed the infusion to assist its development of the MD-12, a 400 seat wide-bodied tri-jet which would compete with Boeing's 747. Currently, it produces only the narrow-body MD-80 and wide-body MD-11 (later versions of the DC-9 and DC-10, respectively).<sup>136</sup>

<sup>130</sup> Airbus Captures 35 Percent of Big Transport Market in 1990, AVIATION DAILY (Jan. 10, 1991), at 61.

<sup>131</sup> Wartzman, Carey & Mark, A McDonnell Deal in Asia Would Jolt the Airliner Industry, Wall St. J., Nov. 15, 1991, at A9.

<sup>132</sup> U.S., EC Escalate Battle Over Airbus Exchange Rate Subsidy, AVIATION DAILY (Feb. 15, 1991), at 311.

<sup>133</sup> Cole, Airbus's Lease Terms on Delta Jet Order May Inflame U.S.-Europe Trade Tension, Wall St. J., Mar. 12, 1992, at A3.

<sup>134</sup> Wartzman, Carey & Mark, A McDonnell Deal in Asia Would Jolt the Airliner Industry, Wall St. J., Nov. 15, 1991, at 1.

<sup>135</sup> Wartzman, Carey & Mark, A McDonnell Deal in Asia Would Jolt the Airliner Industry, Wall St. J., Nov. 15, 1991, at 1; Will They Ever Fly Again, ECONOMIST (Mar. 7, 1992), at 67.

<sup>136</sup> Wartzman, Carey & Mark, A McDonnell Deal in Asia Would Jolt the Airliner Industry, Wall St. J., Nov. 15, 1991, at A9.

Some sources predict that worldwide traffic will double by the year 2005, requiring some 600 new aircraft a year.<sup>137</sup> If so, the global commercial airline industry will need nearly 9,000 new aircraft through the year 2005, at a cost of some \$617 billion.<sup>138</sup>

Boeing predicts that the world's airlines will take delivery of nearly 6,000 new jets, worth about \$380 billion, by the year 2000, and buy another \$500 billion of new aircraft in the decade after that.<sup>139</sup> Passenger traffic is estimated to grow 5% a year for the next two decades (it grew 7% a year in the two decades preceding 1990).<sup>140</sup> Others see worldwide traffic slowing to between 3%-5%, half its previous rate.<sup>141</sup>

Much concern has been levied at the age of the U.S. fleet, the oldest in the developed world. The economic design life of a typical aircraft is 20 years or 60,000 cycles.<sup>142</sup> Thirty-one percent of the U.S. fleet exceeds the economic design goals originally set by the manufacturers.<sup>143</sup> By 1989, 32% of the U.S. fleet was more than 20 years old, the GAO predicts 64% will be by the year 2000.<sup>144</sup> Aircraft corrosion and structural fatigue have been a factor in at least 36 aviation accidents since 1983.<sup>145</sup>

<sup>137</sup> Will Boeing's Tails Turn White?, *ECONOMIST* (Apr. 13, 1991), at 61.

<sup>138</sup> Intelligence, *AVIATION DAILY* (Feb. 25, 1991), at 369.

<sup>139</sup> Will They Ever Fly Again, *ECONOMICS* (Mar. 7, 1992), at 67.

<sup>140</sup> Will They Ever Fly Again, *ECONOMICS* (Mar. 7, 1992), at 67.

<sup>141</sup> James, *Airline Economics in the Year 2000*, *IATA REVIEW* (Apr. 1991), at 20, 21.

<sup>142</sup> Brannen, *The Problem of Aging Aircraft: Is Mandatory Retirement the Answer?*, 57 J. AIR L. & COM. 425, 433 (1991).

<sup>143</sup> GAO, *Testimony of Kenneth Mead Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation: Meeting the Aging Aircraft Challenge* (Oct. 10, 1989); *The Financial Condition of the Airline Industry and the Adequacy of Competition*, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. 550-72 (1991) (statement of Kenneth Mead).

<sup>144</sup> Brannen, *The Problem of Aging Aircraft: Is Mandatory Retirement the Answer?*, 57 J. AIR L. & COM. 425, 432 n. 42 (1991).

<sup>145</sup> Brannen, *The Problem of Aging Aircraft: Is Mandatory Retirement the Answer?*, 57 J. AIR L. & COM. 425, 425-26 (1991).

AVERAGE FLEET AGES IN YEARS <sup>146</sup>		AVERAGE AGE
AIRLINE	NUMBER OF AIRCRAFT	
	1990	1989 1991
American	510	9.4 9.6
Continental	331	11.0 13.5
Delta	421	8.7 8.6
Eastern	177	13.8 15.3
Northwest	326	14.1 15.6
Pan Am	162	12.8 15.9
TWA	213	14.3 16.6
United	443	13.6 12.1
USAir	453	9.0 9.3

By the time of Pan Am collapsed in December 1991, the average age of its fleet had grown to 18 years.<sup>147</sup> In contrast, the average age of Singapore Airlines' fleet is only four years and nine months.<sup>148</sup> Japan Air Lines' fleet is 8.6 years old, still younger than any U.S. airlines.<sup>149</sup>

In 1990, concern over aircraft noise led Congress to promulgate legislation banning most of the 2,300 Stage Two aircraft in the U.S. fleet from U.S. airports by the end of 1999. Waivers can be granted until the end of the year 2003 if the airline has 85% of its fleet satisfying Stage Three requirements by July 1, 1999.<sup>150</sup> This raises significant concerns among U.S. carriers whose fleets are aging. The following chart reveals the proportion of each major airline's fleet in Stage Two.

<sup>146</sup> Wall St. J., Mar. 31, 1989, at B1; AVIATION DAILY (Aug. 1, 1991), at 209. The number of aircraft was taken from an Appendix to a Memorandum for the Honorable James L. Oberstar from Samuel K. Skinner (Oct. 25, 1990).

<sup>147</sup> Bulk of Pan Am Fleet Owned by Other Companies, AVIATION DAILY (Dec. 6, 1991), at 412.

<sup>148</sup> Singapore Airlines 747-400 Orders Near \$10 Billion Mark, AVIATION DAILY (Mar. 18, 1991), at 501.

<sup>149</sup> Global Dogfight: World's Major Airlines Scramble to Get Ready for a World-Wide Competitive Battle, Wall St. J., Jan. 14, 1992, at A9.

<sup>150</sup> Congress Mandates Phaseout of Stage 2 Aircraft By End of Century, AVIATION DAILY (Oct. 30, 1990), at 201.

PERCENTAGE OF FLEETS IN STAGE TWO AIRCRAFT (1991)<sup>151</sup>

American	34%
Continental	50%
Delta	54%
Eastern	70%
Northwest	65%
Pan Am	60%
TWA	55%
United	49%
USAir	55%

In regulations promulgated in 1991, the FAA gave the airlines the option of complying either by adding Stage Three aircraft to their fleets, or reducing the number of Stage Two planes. The FAA timetable calls for the phaseout of 25% of Stage Two aircraft by the end of 1994, a 50% reduction by the end of 1996, and a 75% reduction by the end of 1998. Their fleets must be 100% Stage Three by Dec. 31, 1999, except for a few limited waivers. However, the FAA failed to preempt local airports which impose phaseout schedules more stringent than the federal schedule.<sup>152</sup>

The phasing out of Stage Two aircraft mandated by the year 2000 is estimated to cost as little as \$880 million (about 25 cents per passenger, according to the Federal Aviation Administration [FAA]) \$2.1 billion (according to the U.S. General Accounting Office [GAO]), or as much as \$100 billion (according to the Air Transport Association [ATA]).<sup>153</sup> The lower estimates are based on compliance solely by hushkitting, and the larger estimate assumes replacing all Stage Two with new Stage Three aircraft.<sup>154</sup>

151 Stage 2 Fleets, AVIATION DAILY (Sept. 25, 1991), at 568.

152 Airlines Can Grow to Stage 3 Compliance; Preemption Left to the Courts, AVIATION DAILY (Sept. 25, 1991), at 567-68.

153 GAO Says Costs of Stage 2 Phaseout Much Lower than Industry Forecasts, AVIATION DAILY (July 18, 1991), at 105; Airlines Can Grow to Stage 3 Compliance; Preemption Left to the Courts, AVIATION DAILY (Sept. 25, 1991), at 567-68.

154 Airlines Can Grow to Stage 3 Compliance; Preemption Left to the Courts, AVIATION DAILY (Sept. 25, 1991), at 567-68.

In the late 1980s, major carriers placed massive orders for new aircraft. In 1986, Northwest ordered 50 Airbus A320s for \$3.2 billion; in 1989, it ordered 90 aircraft worth \$5.2 billion.<sup>155</sup> In 1988, Delta ordered 215 jets, expanding that to 260 the following year.<sup>156</sup> By 1992, Delta had 549 jets in its fleet, and another 454 on order or option.<sup>157</sup> In 1989, United placed a record \$15.7 billion order for 370 Boeing 737s and 757s; American ordered 561 planes, totaling \$14.5 billion.<sup>158</sup>

But the industry reversed itself in the early 1990s. Nearly 140 jet orders were cancelled in 1991, the largest number of cancellations since 1982. Total new orders for 1991 were only 467, the worst year since 368 orders were placed in 1984.<sup>159</sup> Only \$32 billion in new planes were ordered, compared to \$90 billion in 1989.<sup>160</sup> By 1992, more than 1,000 aircraft, about 10% of the world's commercial fleet, was parked in deserts or on the edge of airports.<sup>161</sup>

American Airlines cut its five-year capital spending program by \$8 billion, from \$21 billion to \$13 billion.<sup>162</sup> In early 1992, United announced the cancellation of orders for 122 Boeing aircraft, mostly 737s and 757s, used in its domestic system, cutting its spending on aircraft by 22% between 1992 and 1995, and cutting capital spending by \$6.7 billion, down from nearly \$19 billion; United still intends to take delivery on 156 planes from 1992-1995,

<sup>155</sup> Nomani, NWA to Unveil Major Order With Boeing, *Wall St. J.*, Oct. 11, 1989, at A4.

<sup>156</sup> Waldman & Wartzman, Delta Air Sets Orders, Options for \$10 Billion, *Wall St. J.*, Nov. 15, 1989, at A3.

<sup>157</sup> Cole, Airbus's Lease Terms on Delta Jet Order May Inflame U.S.-Europe Trade Tension, *Wall St. J.*, Mar. 12, 1992, at A3.

<sup>158</sup> O'Brian & Valente, Crandall's American Is Unlikely Recipient of \$8 Billion Trump Bid, *Wall St. J.*, Oct. 6, 1989, at 1.

<sup>159</sup> Aircraft 1991 Order Cancellations Highest In a Decade, *AVIATION DAILY* (Jan. 24, 1992), at 149.

<sup>160</sup> Will They Ever Fly Again?, *THE ECONOMIST* (Mar. 7, 1992), at 67.

<sup>161</sup> Will They Ever Fly Again?, *THE ECONOMIST* (Mar. 7, 1992), at 67.

<sup>162</sup> Pulley & Harris, Jr., UAL to Trim Capital Outlays by \$3.6 Billion, *Wall St. J.*, Feb. 11, 1992, at A3, A8.

including many wide-bodied aircraft to serve its international routes.<sup>163</sup> Some analysts anticipate that the cut in capacity may enhance carrier profitability.<sup>164</sup>

Excessive capacity is seen as among the most significant problems facing the airline industry.<sup>165</sup> Post deregulation load factors climbed to 60% from the 54% it averaged in the 1971-78 period.<sup>166</sup> However the break-even level increased from 53% in the pre-deregulation period to 62% after it.<sup>167</sup> But by 1991-92, load factors had fallen to the pre-deregulation levels of 54-56%.<sup>168</sup>

Aviation litigation has severely strained the economic resources of general aircraft manufacturers. The general aviation industry sold only 1,021 aircraft in 1991, the lowest number in modern history.<sup>169</sup>

#### B. AIRLINES

Part 121 of the Code of Federal Regulations<sup>170</sup> defines carriers earning more than \$1 billion as "majors." Those earning more than \$100 million but less than \$1 billion are "nationals." And carriers earning less than \$100 million are "regionals."

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<sup>163</sup> Pulley & Harris, Jr., UAL to Trim Capital Outlays by \$3.6 Billion, *Wall St. J.*, Feb. 11, 1992, at A3, A8; UAL Slashes Jet Deliveries by 122, Spending by \$6.7 Billion, *AVIATION DAILY* (Feb. 11, 1992), at 247.

<sup>164</sup> Pulley & Harris, Jr., UAL to Trim Capital Outlays by \$3.6 Billion, *Wall St. J.*, Feb. 11, 1992, at A3, A8.

<sup>165</sup> Brenner, *Airline Deregulation -- A Case Study in Public Policy Failure*, *TRANSP. L.J.* 179, 204 (1988) (quoting Michael Levine).

<sup>166</sup> Brenner, *Airline Deregulation -- A Case Study in Public Policy Failure*, *TRANSP. L.J.* 179, 206 (1988).

<sup>167</sup> Brenner, *Airline Deregulation -- A Case Study in Public Policy Failure*, *TRANSP. L.J.* 179, 206 (1988).

<sup>168</sup> O'Brian, *Airlines Seek to Earn More From an Irritated Clientele*, *Wall St. J.*, Mar. 16, 1992, at B1.

<sup>169</sup> General Aviation Sales Reach Historic Low, *AVIATION DAILY* (Jan. 17, 1992), at 100.

<sup>170</sup> 14 CFR 121.

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U.S. MAJOR AND NATIONAL AIRLINES (1992)

As of February 1992, the majors were:

American  
America West\*  
Continental\*  
Delta  
Northwest  
Southwest  
Trans World\*  
United  
USAir

The nationals were:

Alaska  
Aloha  
American Trans Air  
Hawaiian  
Horizon  
Markair  
Midwest Express  
Tower  
Trump Shuttle  
Westair  
\* in bankruptcy

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Commuter airlines, operating fewer than 60 seats, are governed by Part 135 of the Code of Federal Regulations.<sup>171</sup> In 1978, 210 commuter airlines offered passenger service; by 1991, there were but 176, and the largest 50 carried 92% of all commuter passengers.<sup>172</sup>

Of the 148 new carriers reporting financial data to the U.S. Department of Transportation [DOT] since deregulation, as of 1991, only 44 remained.<sup>173</sup>

#### 1. AMERICA WEST

Of the 176 airlines spawned by deregulation, America West is the only one which managed both to make it into the big leagues of the majors and to survive into the 1990s. America West has significant market share at its two hubs -- Phoenix and Las Vegas -- but in

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<sup>171</sup> 14 CFR 135.

<sup>172</sup> TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION 31 (1991).

<sup>173</sup> TRANSPORTATION RESEARCH BOARD, WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION 31 (1991).

neither does it control more than 50% of the market. After a period of rapid and optimistic expansion, it struggles in Chapter 11 bankruptcy. As of this writing, its prospects for survival are less than overwhelming.

## 2. AMERICAN AIRLINES

American Airlines is the largest airline in the Western world, and one of the strongest. Under its tenacious and creative CEO, Robert Crandall, American has been an industry innovator. In 1984, American was the first airline to institute a two-tier wage structure, allowing it to expand at lower cost; today, more than half its employees are on the "B" scale.<sup>174</sup> In 1981, it inaugurated frequent flyer programs.<sup>175</sup> It pioneered computer reservations systems [CRS], and today owns one of the two largest, Sabre.

In addition to expanding its Dallas/Ft. Worth operations into a major hub (it moved its corporate headquarters there from New York in 1979), it established hubs at San Jose, Nashville, Raleigh/Durham and San Juan. American is the second largest airline at Chicago O'Hare, the world's busiest airport, with 34.5% of the market, behind United's 49.7%. It controls 61.5% of Dallas/Ft. Worth (compared to 34.5% flown by Delta), 82.4% of Raleigh-Durham, 65.1% of Nashville, 63.4% of San Juan, and 58.5% of San Jose.

American invested more than \$1 billion in overseas expansion since 1989, beginning with the purchase of Eastern's Latin American routes (which Eastern had earlier bought from bankrupt Braniff). Nonetheless, American Airlines still has a relatively weak presence in the Pacific Rim.<sup>176</sup> American also purchased several of TWA's routes to London Heathrow airport, and a Seattle-Tokyo route from Continental. American had planned to invest \$20 billion in capital spending by 1995, mostly for new, fuel-efficient aircraft, and expanded

<sup>174</sup> Pulley & O'Brian, *Flight Plans: How the Airlines Stack Up*, Wall St. J., June 17, 1991, at B1.

<sup>175</sup> TRANSPORTATION RESEARCH BOARD, *WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION* 54 (1991).

<sup>176</sup> Snapshot of the World's Major International Airlines, Jan. 14, 1992, at A8.

domestic facilities.<sup>177</sup> But as profits plummeted, American rolled back capital spending plans by \$8 billion through the mid-1990s.<sup>178</sup>

American Airlines has the largest fleet in the U.S. industry, with 602 aircraft, of which more than 73% is Stage Three, and an average age of 9.6 years, the second youngest of any major U.S. airline. American anticipated it would have a fleet of 682 planes by 1995, but recent aircraft cancellations probably preclude that.<sup>179</sup>

### 3. CONTINENTAL AIRLINES

Continental is a blend of corporate cultures and airlines. It has been described as "the product of myriad mergers, [with] a raucous recent history that sometimes bordered on the schizophrenic under former chairman Frank Lorenzo. It's a crazy quilt of airlines forged from hostile takeovers, frequent bankruptcies, employee standoffs, midnight firings, and one shocking suicide."<sup>180</sup>

In the early 1980s, Frank Lorenzo's Texas International acquired larger Continental in a leveraged buy-out; the two were consolidated. In December 1990, Continental Airlines entered Chapter 11 bankruptcy for the second time (some call it Chapter 22 bankruptcy). It had first entered bankruptcy in 1983 (at which time it tore up its union contracts), and emerged from it in 1986, in time for Lorenzo to go on a buying binge, picking up People Express (including Frontier Airlines, Britt and PBA), Eastern Airlines, and Rocky Mountain Airways.

Much of Continental's debt was put on in its acquisition of People Express, Frontier and Eastern, which raised its long-term debt obligations to more than 78% of its assets, almost twice the percentage of the four largest airlines.<sup>181</sup> In addition to Continental's debt, between \$285 million and \$403 million may come its way out of the Eastern Airlines' bankruptcy as a

<sup>177</sup> Pulley & O'Brian, *Flight Plans: How the Airlines Stack Up*, Wall St. J., June 17, 1991, at B1.

<sup>178</sup> Snapshot of the World's Major International Airlines, Wall St. J., Jan. 14, 1992, at A8.

<sup>179</sup> AMR, THIRD QUARTER REPORT 4 (1991).

<sup>180</sup> Lollar, *It's Not Easy Being Fourth . . . Or Fifth*, FREQUENT FLYER (Nov. 1991), at 8.

<sup>181</sup> Continental, AVIATION DAILY (Dec. 19, 1990), at 525.

result of the transfer of assets out of Eastern into the Texas Air empire by Frank Lorenzo at less than fair market value, as well as \$752 million in Eastern's unfunded pension liability.<sup>182</sup>

In 1990, Continental Airline Holdings lost \$2.34 billion on revenues of \$6.23 billion; in 1991, it lost \$341 million on revenue of \$5.4 billion.<sup>183</sup> Lorenzo was ousted, although the company continues to suffer from an annual turnover of Presidents, a dominant management strategy for Continental throughout the 1980s.

Continental is dominant in Houston (80.2%) and Newark (53.2%). It is the largest airline in Cleveland (36.7%), and the second largest in Denver (35.5%, behind United with 47.7%).

In 1992, Continental proposed a plan of reorganization to trade debt for equity, wiping out the stockholders, thereby reducing the company's long-term liability from \$5.1 billion to \$1.7 billion, and rolling back its interest expenses by \$270 million a year.<sup>184</sup> SAS, which owned nearly 19% of Continental, has written down its investment to zero.

#### 4. DELTA AIR LINES

Delta is generally regarded as providing among the highest level of service in the industry and having the most loyal and best paid employees. It is also known as among the most conservative of airlines, although it seems to be shedding that image as it has recently gone on a buying spree. Before it acquired Salt Lake City hubbed Western Airlines for \$860 million in 1986, Delta had not acquired an airline since it purchased Northeast in 1972.<sup>185</sup>

<sup>182</sup> See Mahoney, Airline Merger Brewing, Denver Post, Dec. 13, 1991, at 1A, 14A; Eastern Assets, AVIATION DAILY (Jan. 22, 1991), at 134; and Continental Withholds \$17 Million Pension Payment, AVIATION DAILY (Oct. 10, 1991), at 67.

<sup>183</sup> Mahoney, Continental Ekes Out Fourth-Quarter Profit, Denver Post, Feb. 8, 1992, at 1C, 2C.  
<sup>184</sup> Mahoney, No Layoffs in Continental Plan, Stockholders Would Lose Equity, Denver Post, Feb. 7, 1992, at 1C; O'Brian, Continental Air Reorganization Plan Erases Stock, Makes Creditors Owners, Wall St. J., Feb. 7, 1992, at A5.

<sup>185</sup> Delta to Buy Western Air for \$860 Million, Wall St. J., Sept. 10, 1986, at 3.

Delta is well positioned domestically with its hubs of Atlanta (89.2%), Cincinnati (88.1%) and Salt Lake City (82.6%), and well positioned internationally with its purchase of Pan Am's major transatlantic and European services, hubbed in Frankfurt, and its Boston-Washington-New York shuttle.<sup>186</sup> Delta is best positioned to capitalize on the economic growth of Eastern Europe, although with European Community liberalization, EC carriers will likely enter the type of destructive competition which characterized the domestic U.S. market in the 1980s. Delta has lost an enormous amount of money attempting to digest its Pan Am European acquisition. Delta considered building a Taipei hub and expanding in Asia.<sup>187</sup> With Eastern gone, Delta will dominate the southeast, and will fight smaller USAir for dominance of the northeast.

In order to build global alliances and avoid a takeover attempt, in the late 1980s Delta traded blocks of 5% of its stock with both Singapore Airlines and Swissair, known in the industry as two of the highest service airlines in the world.

One potential problem for Delta lies in litigation flowing from the demise of Pan Am. Pan Am folded on December 4, 1991, a day after Delta announced it would cut the flow of money it had allegedly promised. One suit, seeking \$1.1 billion was filed by Pan Am employees thrown out of work.<sup>188</sup>

##### 5. NORTHWEST AIRLINES

Northwest entered deregulation with perhaps the strongest balance sheet in the industry. Unfortunately, this would make it a prime candidate for a leveraged buy-out.

In 1986, Northwest acquired Republic Airlines for \$884 million, itself a product of the mergers of North Central, Southern and Hughes Airwest. That gave Northwest significant domestic feed for its international routes (it is among the strongest transPacific carriers) and

<sup>186</sup> See Lollar, Delta's Wild Blue Yonder, FREQUENT FLYER (Oct. 1991), at 8.

<sup>187</sup> Snapshot of the World's Major International Airlines, Wall St. J., Jan. 14, 1992, at A8.

<sup>188</sup> Delta Sued Again Over Pan Am Deal, Denver Post, Mar. 13, 1992, at 2C.

control of the hubs of Minneapolis/St. Paul (81.3%), Detroit (73.1%) and Memphis (82.1%). Of the three, Detroit is potentially the most important, with its huge O&D base of 4.7 million people.

In a transaction which increased Northwest's debt-to-equity ratio from 0.42/1 to 5.85/1, in August 1989, Wings Holdings, Inc., acquired control of Northwest with 81.5% debt and 18.5% equity. Wings' debt was \$3.1 billion, almost two-thirds of which was put up by Japanese banks. Equity was \$705 million, of which Alfred Checchi, Gary Wilson and Frederic Malek put up only \$40 million (for which they received about half the voting and nonvoting common stock), KLM (a Netherlands airline) put up \$400 million (or 57% of the equity, for which KLM received 70% of Wings' nonvoting preferred stock, 31% of its nonvoting common stock, and 4.9% of its voting common stock, as well as a warrant allowing it to convert up to \$50 million of its preferred stock into common stock, some of which could be voting), and Elders IXL (an Australian company) put up \$80 million (or 11% of the equity, for which it received 10% of Wings' nonvoting preferred stock, 16% of its nonvoting common stock, and 15.4% of its voting stock).<sup>189</sup>

Northwest spent more than \$3 billion on the LBO. That is more than the purchase price of Pan Am's transpacific division (bought by United for \$715 million), Western Airlines (bought by Delta for \$860 million), Ozark Airlines (bought by TWA for \$250 million), Eastern Airlines and People Express (bought by Texas Air for \$676 million and \$112 million, respectively), and Air Cal (bought by American for \$225 million), *combined*. For these purchases, these airlines acquired significant operating assets and market share. For its purchase, Northwest acquired the talents of Alfred Checchi.

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<sup>189</sup> In the matter of the Acquisition of Northwest Airlines by Wings Holdings, Inc., DOT Order 91-141 (1991), at 2.

Price Waterhouse recently concluded that Northwest was at a "critical juncture" and was facing "significant hurdles."<sup>190</sup> Most stem from the \$3.65 billion leveraged buy-out of the company by Alfred Checchi and partners (Wings Holdings, Inc.) in 1989, which saddled an almost debt-free company with enormous debt.<sup>191</sup> Both mergers and route sales have been explored to shore up its financial condition and strategic position.<sup>192</sup> Northwest has made a \$7 billion commitment for new aircraft through 1995, which it desperately needs, for its fleet is 15.6 years old on average, and 65% is Stage Two.

Northwest earned record profits of \$135 million in 1988; it earned \$67 million in 1989. But it lost \$302 million in 1990, and \$317 million in 1991.<sup>193</sup> According to one source, the heavy debt burden put on by the Checchi LBO, coupled with these tremendous losses, have caused Northwest's debt-to-equity ratio to soar to an unbelievable 30 to 1 (\$4.2 billion in debt versus \$141 million in equity).<sup>194</sup> Others estimate that Northwest carries \$1.4 billion in debt.<sup>195</sup>

Annual interest expenses at Northwest are \$7,835 per employee, compared to \$2,534, \$1,612 and \$928 at United, American and Delta, respectively.<sup>196</sup> Under Checchi, expenses have grown, and international routes, traditionally the solid profit base, have turned unprofitable.<sup>197</sup> However, Northwest's deteriorating cash position was much bolstered by an infusion of several hundred million dollars by the state of Minnesota to lure the construction of maintenance bases in the state.

<sup>190</sup> Snapshot of the World's Major International Airlines, Jan. 14, 1992, at A8.

<sup>191</sup> Nomani, NWA Weighs Sale of Routes, Merger Option, Wall St. J., Feb. 11, 1991, at A3.

<sup>192</sup> Nomani, NWA Weighs Sale of Routes, Merger Option, Wall St. J., Feb. 11, 1991, at A3.

<sup>193</sup> Laing, Losing Altitude: Heavy Debt Load, a Legacy of Its LBO, Weighs Down NWA, BARRONS (Feb. 17, 1992), at 8.

<sup>194</sup> Laing, Losing Altitude: Heavy Debt Load, a Legacy of Its LBO, Weighs Down NWA, BARRONS (Feb. 17, 1992), at 8.

<sup>195</sup> Lollar, It's Not Easy Being Fourth . . . Or Fifth, FREQUENT FLYER (Nov. 1991), at 8, 12.

<sup>196</sup> Laing, Losing Altitude: Heavy Debt Load, a Legacy of Its LBO, Weighs Down NWA, BARRONS (Feb. 17, 1992), at 8.

<sup>197</sup> Laing, Losing Altitude: Heavy Debt Load, a Legacy of Its LBO, Weighs Down NWA, BARRONS (Feb. 17, 1992), at 8.

The difficulty Northwest faces is debt, debt and debt, followed by United's growing competitive threat in the Pacific, and United-American-Delta's expansion in the Atlantic.

## 6. SOUTHWEST AIRLINES

Under maverick Herb Kelleher, Southwest has been profitable by following a course alien to the other airlines. Instead of establishing a hub-and-spoke system, Southwest flies a linear route system across 14 states focused on frequent, short flights with no-frills service exclusively in Boeing 737s between smaller cities not generally served by the megacarriers.<sup>198</sup> "We have sort of lived off the scraps of the table of the mega-carriers," said Kelleher. "But I know lots of fat little puppies that have lived off table scraps."<sup>199</sup>

Southwest began in 1971 as a Texas intrastate airline flying 737s between Houston, Dallas and San Antonio. The Wright Amendment restricts service at close-in Houston Hobby and Dallas Love airports to airlines flying from states contiguous to Texas. This has enabled Southwest to maintain a virtual monopoly at both airports, virtually free from competition at either. Southwest controls 70% of Houston Hobby and 100% of Dallas Love airports. Southwest was the only major airline to earn a profit in 1991.<sup>200</sup>

## 7. TRANS WORLD AIRLINES

TWA entered deregulation as the nation's fourth largest airline, although it had earlier suffered from the eccentricities of its owner Howard Hughes. In the late 1970s, TWA diversified into several nonseasonal industries to balance its profit flow -- Hilton International, Century 21, Canteen Corporation and Spartan Foods. This diversion was to cost it market share. Ultimately, it spun off these properties.

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<sup>198</sup> Pulley & O'Brian, *Flight Plans: How the Airlines Stack Up*, Wall St. J., June 17, 1991, at B1.

<sup>199</sup> American Trying to Cope With Low-Cost Success Southwest, *AVIATION DAILY* (Feb. 18, 1992), at 287.

<sup>200</sup> American Trying to Cope With Low-Cost Success Southwest, *AVIATION DAILY* (Feb. 18, 1992), at 287.

In the mid-1980s, TWA became the target of Frank Lorenzo, then Carl Icahn. Labor was willing to surrender significant concessions to Icahn to avoid the dreaded union-buster Lorenzo. Shortly thereafter, TWA executed a pre-existing plan to acquire Ozark, giving it a strangle hold on St. Louis Lambert International Airport, where it controls 76.4% of the market.

After its acquisition, Icahn took the company private and began cannibalizing many of its properties to finance raids on other companies. In 1992, Icahn announced a "pre-packaged" Chapter 11 filing, beyond which some analysts predict only another 18 to 36 months of life for this anemic airline.<sup>201</sup> One analyst gave TWA only a 50-50 chance of reorganizing successfully.<sup>202</sup>

In 1990, TWA carried more than \$2.5 billion in debt.<sup>203</sup> By 1991, it was reported that TWA's debt had been reduced to \$1.4 billion.<sup>204</sup> Interest payments recently exceeded 8% at both TWA and Eastern -- the highest in the industry.<sup>205</sup> TWA flies the oldest fleet of aircraft of any major airline in the U.S. system (an average of 16.6 years) and consistently ranks among the worst airlines in terms of consumer complaints and on-time performance.

## 8. UNITED AIRLINES

United was the only major airline to support deregulation. As the nation's largest carrier, with 17% of the passenger market, it thought itself better able to grow without the benevolent presence of the Civil Aeronautics Board. But under Richard Ferris, it blundered

<sup>201</sup> Snapshot of the World's Major International Airlines, Jan. 14, 1992, at A8.

<sup>202</sup> TWA Surprises Industry with Early Chapter 11 Bankruptcy Filing, AVIATION DAILY (Feb. 3, 1992), at 199.

<sup>203</sup> Carl Icahn Considering Sale of TWA in Two-Step Process, AVIATION DAILY (May 7, 1990), at 247. Other sources report that TWA owed \$3.2 billion in long-term debt, lease obligations and unfunded pension liability. Smith, Pan Am Stock Soars as Icahn Makes New Bid, Wall St. J., Dec. 18, 1990, at A4.

<sup>204</sup> Mahoney, Airline Merger Brewing, Denver Post, Dec. 13, 1991, at 1A, 14A.

<sup>205</sup> AVIATION DAILY (July 30, 1990), at 192; AVIATION DAILY (Feb. 19, 1991), at 326; AVIATION DAILY (Nov. 7, 1991), at 248.

almost immediately, by pulling out of short haul markets (selling off scores of 737s, for example), and concentrating on long-haul traffic. United soon learned that the smaller airlines were not content to feed it, inaugurating their own long-haul routes. United soon reversed course, began buying smaller aircraft, and establishing hub-and-spoke systems.

United also got off course by buying related travel companies -- it added Hertz Rent-a-Car and Hilton International Hotels to its existing Westin Hotel Chain under a holding company awkwardly named Allegis. Whatever the potential value of creating a one-stop travel conglomerate, United failed to integrate the system; the corporate raiders began to circle, and United reversed course again, spinning off the non-airline properties, and dropping the Allegis label.

In the meantime, United's market share had slipped significantly. It was not able to achieve its pre-deregulation market presence until 1991, by which time American had surpassed it as the nation's largest airline.

But United did a couple of things quite right. It established hub systems in San Francisco, Denver, Chicago and Washington (Dulles), covering both coasts and the interior with hubs spread about quarter way across the continent. It is the largest airline at Chicago O'Hare (49.7%), Denver (47.7%), San Francisco (39.4%), and Washington Dulles (39.4%). In 1991, United announced its purchase of Air Wisconsin, which will increase its number of slots at Chicago O'Hare, the world's largest airport, by 16%, giving it clear dominance over American. American has filed an antitrust suit to block the transfer. Midway has disappeared from the Chicago market, which should allow both carriers to raise prices.

United also seized many the primary international routes of a disintegrating Pan Am. United purchased Pan Am's transpacific operations for \$715 million, its London Heathrow and fifth-freedom beyond rights for \$400 million, and its Latin American operations for \$135

million.<sup>206</sup> Most analysts predict international traffic will grow at a faster pace than the domestic market throughout the 1990s. United's fleet is growing at the rate of about one new aircraft a week, although it has recently cancelled a large block of smaller aircraft.<sup>207</sup> It left standing orders for Boeing 747 and 777 planes, which will be fed into United's growing international system. United's Apollo is one of the two strongest computer reservations systems.

United lost \$94.5 million in 1990, and a record \$331.9 million in 1991.<sup>208</sup> CEO Stephen Wolf was paid a record \$18.3 million in compensation in 1990, despite his company's poor performance.<sup>209</sup> As a consequence of United's unprecedented losses, it cut capital spending by \$6.7 billion, or 35%, between 1993 and 1995.<sup>210</sup> Mr. Wolf's compensation was also pared in 1991, to a paltry \$575,000.<sup>211</sup>

#### 9. USAIR

In 1987, USAir purchased Pacific Southwest Airlines for \$400 million, and Piedmont for \$1.56 billion. In 1989, USAir merged operations with Piedmont, although it has had considerable difficulty digesting that acquisition, with both service and profitability turning south.<sup>212</sup> USAir had two miserable years financially in 1990-91, losing several hundred million dollars each year. USAir suffered a record net loss of \$454 million in 1990, and \$305 million in 1991.<sup>213</sup> In order to cut costs, USAir pulled out of the competitive California

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206 Snapshot of the World's Major International Airlines, Jan. 14, 1992, at A8.

207 Pulley & O'Brian, Flight Plans: How the Airlines Stack Up, Wall St. J., June 17, 1991, at B1.

208 United Lays Off 534, Warns of More Cuts, Denver Post, Feb. 22, 1992, at 1C.

209 SEC Wants to See Clear Explanation of Executive Compensation, AVIATION DAILY (Feb. 18, 1992), at 287.

210 United Lays Off 534, Warns of More Cuts, Denver Post, Feb. 22, 1992, at 1C.

211 Pulley, For UAL's Wolf, Compensation Fell Sharply in 1991, Wall St. J., Mar. 30, 1992, at B6.

212 USAir Scaling Back Expansion Plans for 12-24 Months, AVIATION DAILY (Aug. 15, 1990), at 286.

213 Pulley, USAir May Have Trouble Getting Unions to Agree to Other Workers' Concessions, Wall St. J., Oct. 7, 1991, at A4; Pulley, USAir's Vice Chairman Malin Ousted, Apparently Blamed for Carrier's Woes, Wall St. J., Feb. 5, 1992, at A12.

markets it entered with the PSA purchase, laid off 7,000 employees, and asked the rest for 20% wage concessions.<sup>214</sup>

USAir has relatively weak presence internationally, having bought TWA's authority to London from Philadelphia and Boston for \$50 million.<sup>215</sup> It may also need to trim a few of its hubs east of the Mississippi.<sup>216</sup> It now dominates Pittsburgh (89.6%), Charlotte (95.2%) and Baltimore (68.1%), and with the demise of Eastern and Midway has significant market share in Philadelphia ((52.9%). It has dismantled the once-profitable Dayton hub it inherited from Piedmont, where in 1990 it had 77.8% of the market. USAir solidified its east coast operations with the purchase of Continental's new LaGuardia terminal and landing slots for \$61 million, and the signing of an agreement to operate (and an option to buy) the Trump shuttle, which flies between New York's LaGuardia, Boston Logan, and Washington National Airports.<sup>217</sup> The shuttle is saddled with some \$380 million in debt, an enormous burden for such a small airline.<sup>218</sup> Unfortunately, USAir must compete with mighty Delta in the shuttle market. USAir holds 168 jet slots and 28 commuter slots at LaGuardia, and 150 jet slots and 148 commuter slots at Washington National Airport.<sup>219</sup> USAir has a relatively young fleet for a U.S. carrier, at 9.3 years on average.

### C. AIRPORTS

In 1991, some 23 new airports were under construction somewhere in the world, with Denver International Airport scheduled to have the most runways -- six -- and to be the largest (at 53 square miles, covering a land mass twice the size of Manhattan Island).<sup>220</sup> No major

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<sup>214</sup> Pulley, USAir May Have Trouble Getting Unions to Agree to Other Workers' Concessions, *Wall St. J.*, Oct. 7, 1991, at A4.

<sup>215</sup> Snapshot of the World's Major International Airlines, Jan. 14, 1992, at A8.

<sup>216</sup> Pulley, USAir May Have Trouble Getting Unions to Agree to Other Workers' Concessions, *Wall St. J.*, Oct. 7, 1991, at A4.

<sup>217</sup> Takemoto, Go East, *FREQUENT FLYER* (Mar. 1992), at 8.

<sup>218</sup> See USAir Plan to Run Trump Shuttle Gets Approval from U.S., *Wall St. J.*, Mar. 30, 1992, at A4.

<sup>219</sup> Continental Selling LaGuardia Assets to USAir, *AVIATION DAILY* (Nov. 19, 1991), at 298.

<sup>220</sup> Intelligence, *AVIATION DAILY* (May 21, 1991), at 345.

airport had been built in the United States since Dallas/Ft. Worth International Airport opened in 1974 and Atlanta Hartsfield International Airport was reconfigured on its existing property in 1980. The most expensive U.S. airport on the drawing board is Chicago's Calumet, projected to open in the year 2005 at a cost of \$10.8 billion.<sup>221</sup>

Subsequent to deregulation, airlines began consolidating their operations around "fortress" hubs. Hubs account for 70% of the flights offered by domestic airlines.<sup>222</sup> In selecting a city to serve as a hub, an airline looks for one with some of the following characteristics: (1) an interior point geographically situated for flow, preferably east to west, since that is the routing of most business travelers (the most lucrative share of the market); (2) a large population base to enhance origin and destination [O&D] traffic, preferably white collar (again, because business travelers pay more for air transportation); and (3) preferably, no nearby hubs or competing airports dominated by another airline.

According to the 1990 census, the largest metropolitan area population of U.S. cities was as follows:

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LARGEST U.S. METROPOLITAN AREAS<sup>223</sup>  
(1990)

Metropolitan Area	Population (millions)
1. New York	18.1
2. Los Angeles	14.5
3. Chicago	8.1
4. San Francisco	6.3
5. Philadelphia	5.9
6. Detroit	4.7
7. Boston	4.2
8. Washington	3.9
9. Dallas	3.9
10. Houston	3.7
11. Miami	3.2
12. Atlanta	2.8

<sup>221</sup> Illinois and Chicago Cut Deal to Build Lake Calumet Airport, AVIATION DAILY (Feb. 21, 1992), at 311.

<sup>222</sup> American-Sponsored Study Blasts Criticism of Hubs, AVIATION DAILY (July 31, 1990), at 197.

<sup>223</sup> U.S. Statistics 797 (1991).

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13. Cleveland	2.8
14. Seattle	2.6
15. San Diego	2.5
16. Minneapolis	2.5
17. St. Louis	2.4
18. Baltimore	2.4
19. Pittsburgh	2.2
20. Phoenix	2.1
21. Tampa	2.0
22. Denver	1.8
23. Cincinnati	1.7
24. Milwaukee	1.6
25. Kansas City	1.6
34. Charlotte	1.2
38. Salt Lake City	1.1
40. Nashville	1.0
41. Memphis	1.0
44. Dayton	1.0
54. Raleigh-Durham	0.7

The following chart lists the largest airports in the United States:

TEN LARGEST U.S. AIRPORTS (1990)<sup>224</sup>

AIRPORT	TOTAL PASSENGERS	SCHEDULED OPERATIONS
Chicago O'Hare	58,775,486	775,687
Dallas/Ft. Worth	48,915,464	713,958
Atlanta	47,629,438	569,418
Los Angeles	45,530,880	612,428
San Francisco	30,355,338	397,524
New York Kennedy	29,428,400	282,126
Denver	27,383,602	305,660
Miami	25,838,398	281,180
New York LaGuardia	22,789,260	333,512
Newark	22,207,200	356,957

Chicago dominates U.S. air transportation because of geographic proximity and huge metropolitan population (8 million people, compared to Detroit's 4.7 million, St. Louis' 2.4 million, or Minneapolis' 2.5 million). Dallas dominates the south central region, and Atlanta the southeast, for the same reasons -- population base and geographic proximity. Atlanta, for

<sup>224</sup> U.S. Large Airport Traffic, AVIATION DAILY (Aug. 15, 1990), at 309. Enplaned passenger figures have been doubled to approximate total passengers, the standard used in the following chart for foreign airports. However, the reader should beware that a doubling of enplaned passengers may not be precisely the total number of passengers flown through the airport.

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example, has but one airport serving a metropolitan population of 2.8 million compared to the surrounding southern hubs of Charlotte, Nashville, Raleigh, and Memphis of less than half the people. As we shall see, the three largest U.S. airports are dominated by the three largest U.S. airlines -- American, Delta and United.

Compare these data with the number of passengers and operations at the largest foreign airports:

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TEN LARGEST FOREIGN AIRPORTS (1990)<sup>225</sup>

AIRPORT	TOTAL PASSENGERS	COMMERCIAL OPERATIONS
London Heathrow	42,647,235	388,289
Frankfurt	29,631,427	324,387
Paris Orly	24,205,570	191,421
Paris Charles de Gaulle	22,094,122	233,000
London Gatwick	21,047,089	203,211
Stockholm	14,822,450	257,606
Copenhagen	12,080,978	190,767
Dusseldorf	11,576,506	139,147
Munich	11,218,119	163,282
Vancouver	9,912,429	279,788

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Again, the three largest U.S. airlines -- American, Delta and United, have the largest U.S. flag presence at the two largest foreign airports.

The dominant megatrend on the U.S. deregulation landscape is the growth of hubs and spokes. Some call them "fortress hubs", where a single airline controls the lion's share of gates, takeoffs and landings, and passengers. Note that not a single major airport in the United States was dominated by one airline before deregulation; not one had more than 45% of any major airport. The following chart describes the growth in concentration at 20 U.S. airports which have become hubs.

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<sup>225</sup> Worldwide Airport Traffic, AVIATION DAILY (Aug. 15, 1991), at 308.

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 AIRLINE MARKET SHARES AT U.S. CONCENTRATED AIRPORTS<sup>226</sup>  
 (20 airports where a single airline has more than 45% share)

AIRPORT	YEAR				
	1977	1984	1987	1990	1991
ATLANTA					
Delta	52.6			57.1	89.2%
Eastern	40.2			35.7	0
BALTIMORE					
USAir	24.5	13.7	60.0	68.1	
CHARLOTTE					
USAir		nil		93.5	95.2%
CHICAGO O'HARE					
United	46.0			48.9	49.7%
American	25.5			34.1	34.5%
CINCINNATI					
Delta	35.0	55.9	67.6	84.5	88.1%
DALLAS/FT. WORTH					
American	62.0			62.8	61.5%
Delta	22.5			30.1	31.5%
DENVER					
United	39.9			48.8	47.7%
Continental	23.4			34.0	35.5%
DETROIT					
Northwest	11.9	64.9	69.4	73.1%	
HOUSTON					
Continental	20.4	47.1	71.5	77.3	80.2%
MEMPHIS					
Northwest		nil	86.7	82.1	
MINNEAPOLIS/ST. PAUL					
Northwest	45.9	47.8	81.6	80.0	81.3%
NASHVILLE					
American	28.2	22.0	60.2	65.1	
NEWARK					
Continental		nil		48.2	53.2%

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<sup>226</sup> 1977 and 1987 data are taken from CONSUMER REPORTS (June 1988), at 362-67; 1984 data are taken from AVIATION DAILY (Apr. 17, 1985); 1990 data are taken from AVIATION DAILY (Aug. 16, 1991), at 320, and unofficial DOT reports.

PHILADELPHIA					
USAir	23.8		46.1	52.9%	
PHOENIX					
America West	18.4		45.8	47.1%	
Southwest	14.0		21.3	23.2%	
PITTSBURGH					
USAir	43.7	77.2	82.8	87.5	89.6%
RALEIGH/DURHAM					
American	nil		78.6	82.4%	
ST. LOUIS					
TWA	39.1	57.9	82.3	78.7	76.4%
SALT LAKE CITY					
Delta	nil	74.5	83.7	82.6%	
WASHINGTON DULLES					
United	23.9		65.1	67.8%	

Hubbing requires smaller aircraft flying shorter stage lengths and consuming more labor and fuel than a linear route system. Since smaller aircraft, like the hub favorite DC-9s, 727s, and 737s, have higher unit costs per passenger than the larger wide-bodied planes which were the growing trend pre-deregulation, why do airlines prefer them?

The U.S. General Accounting Office [GAO] has found that air fares during 1988-89 at concentrated airports were 27% higher than at unconcentrated facilities.<sup>227</sup> Similarly, the DOT found that fares at concentrated hub airports were 18.7% higher than in more competitive markets of similar distance and size.<sup>228</sup>

The GAO has also found a correlation between higher fares on the one hand, and code-sharing agreements (2% higher), highly congested airports (2% higher), majority-in-interest

<sup>227</sup> GAO, AIRLINE COMPETITION; HIGHER FARES AND REDUCED COMPETITION AT CONCENTRATED AIRPORTS (1990). GAO, AIR FARES AND SERVICE AT CONCENTRATED AIRPORTS (1989). Higher Fares at Concentrated Airports Continue, GAO Says, AVIATION DAILY (July 13, 1990), at 81. Other studies have revealed that fares are more than 18% higher per mile at airports where a single airline controls more than 75% of departures, than the national average. Ground Control, We Seem to Have a Problem, ECONOMIST (Jan. 26, 1991), at 57, 60.

<sup>228</sup> The Financial Condition of the Airline Industry and the Adequacy of Competition, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. VII (1991).

clauses (3% higher), and slot limitations (4% higher), on the other.<sup>229</sup> Of the 3,129 gates at the nation's 66 largest airports, 88% are leased to airlines, and 85% of the leases are for exclusive use; 90% of leased gates are held by the eight largest airlines.<sup>230</sup> According to the GAO, a 65% increase in a carrier's market share on a route translates into 6% higher fares.<sup>231</sup>

As of 1988, the eight largest airlines owned 96% of the takeoff and landing slots at the four slot-constrained airports (i.e., Chicago O'Hare, Washington National, and New York's LaGuardia and Kennedy). In 1985, before the DOT freed airlines to buy and sell slots in the market, these airlines controlled only 70% of the slots.<sup>232</sup> An airline which doubles the number of its gates enjoys a 3.5% increase in fares.<sup>233</sup>

American Airlines owns 528 jet slots at Chicago O'Hare airport, which it values at \$1.056 billion.<sup>234</sup> In 1991, United owned 747 slots at O'Hare, worth nearly \$1.5 billion, and had reached an agreement to purchase Air Wisconsin, which owned 118 commuter slots at O'Hare.<sup>235</sup> American recently offered \$2 million per slot at O'Hare.<sup>236</sup>

#### D. BANKRUPTCIES

Nearly 200 airlines have gone bankrupt since promulgation of the Airline Deregulation Act of 1978.<sup>237</sup> Beginning in 1989, several major airlines entered Chapter 11 (reorganization) bankruptcy, including Eastern, Pan Am, Midway, Continental, America West and TWA.

<sup>229</sup> GAO Releases Findings on Concentration and Limited Entry, AVIATION DAILY (May 15, 1991), at 309.

<sup>230</sup> *Intelligence*, AVIATION DAILY (Aug. 20, 1990), at 323.

<sup>231</sup> GAO Releases Findings on Concentration and Limited Entry, AVIATION DAILY (May 15, 1991), at 309.

<sup>232</sup> GAO, AIRLINE COMPETITION: INDUSTRY OPERATING AND MARKETING PRACTICES LIMIT MARKET ENTRY 4 (1990).

<sup>233</sup> *Id.* at 6.

<sup>234</sup> *Intelligence*, REGIONAL AVIATION (Dec. 2, 1991).

<sup>235</sup> *Id.*

<sup>236</sup> *Id.*

<sup>237</sup> Uchitelle, Off Course, N.Y. Times Magazine (Sept. 1, 1991), at 12, 14.

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To date, not one major airline which entered Chapter 11 has emerged successfully (Continental emerged in 1986, then reentered in 1990). Eastern Air Lines, the nation's oldest (which began operations as Pitcairn Aviation on May 1, 1927) ceased operations on January 18, 1991. Pan Am, which began flying on October 28, 1987, ceased operations on December 5, 1991. Midway Airlines, a creature born of deregulation, ceased operations on November 14, 1991.<sup>238</sup>

As of this writing, three major airlines -- Continental, TWA and America West -- are in bankruptcy. These three airlines account for between 15% and 20% of the market.

Several executives at the healthier airlines (e.g., American and Delta) have urged the Department of Transportation to revoke the certificates of airlines operating in Chapter 11 bankruptcy on grounds that they fail to satisfy the statutory standard of "fitness" required by section 401 of the Federal Aviation Act.<sup>239</sup> To date, DOT has shown little enthusiasm for the idea.

#### E. CONCENTRATION

Prior to deregulation in 1978, 99% of the traffic was carried by the following 19 domestic trunkline and local service carriers:

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#### TRUNKLINE AND LOCAL SERVICE AIRLINES (1978)<sup>240</sup>

Allegheny  
American  
Braniff  
Continental  
Delta  
Eastern  
Frontier

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<sup>238</sup> Noman, Midway Airlines Grounds Fleet as Accord Fails, Wall St. J., Nov. 14, 1991, at A4; Pan Am Shutdown Sets Up Bid War for Latin American Route Authority, AVIATION DAILY (Dec. 5, 1991), at 399-400.

<sup>239</sup> Noman & O'Brian, Healthy Airlines Lash Out at Their Struggling Rivals, Wall St. J., Mar. 17, 1992, at B4.

<sup>240</sup> The Financial Condition of the Airline Industry and the Adequacy of Competition, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. 171 (1991) (statement of Edward R. Beauvais).

Hughes Airwest  
 National  
 North Central  
 Northwest  
 Ozark  
 Pan American  
 Piedmont  
 Southern  
 Texas International  
 Trans World  
 United  
 Western

In 1978, the eight largest airlines had a market share of 80%. However, as the following chart reveals, the market share of the eight largest airlines exceeded 90% in the 1990s, a level unprecedented in the history of U.S. aviation:

**U.S. AIRLINE MARKET SHARES <sup>241</sup>**  
 (in percentage of revenue passenger miles)

AIRLINE	1978	1983	1984	1985	1989	1990	1991
United	17.4	16.0	15.5	12.5	16.4	16.7	18.5
American	12.8	12.7	12.4	13.3	17.3	17.0	18.6
TWA	11.9	10.1	9.6	9.6	8.3	7.5	6.3
Eastern	11.1	10.5	9.9	10.0	2.7	3.7	0
Delta	10.3	9.6	9.2	9.0	14.0	13.0	15.2
Pan Am	9.3	10.7	9.5	8.1	6.8	6.8	4.1
Continental	3.8	3.5	3.7	4.9	9.1	8.6	9.4
Northwest	3.1	6.6	6.7	6.7	10.8	11.3	12.0
USAir	1.8	2.7	2.8	2.9	8.0	7.8	7.7

By January 1992, the three largest U.S. airlines controlled 57% of the market; the top four had 70%.<sup>242</sup> A doubling of an airline's market share on a particular route translates into a price increase of almost nine percent. In 1990, 76% of all passengers in domestic markets flew on routes served by three or fewer airlines; 45% flew on routes served by only one or two carriers.<sup>243</sup>

<sup>241</sup> Washington Post National Weekly Edition, Dec. 10-16, 1990; AVIATION DAILY (Mar. 13, 1985); AVIATION DAILY (Feb. 5, 1986); AVIATION DAILY (Jan. 29, 1991), at 189; AVIATION DAILY (Jan. 21, 1992), at 124.

<sup>242</sup> See American Captures Nearly 21 Percent of Major's RPMs, AVIATION DAILY (Feb. 19, 1992), at 301.

<sup>243</sup> GAO, U.S. AIRLINES; WEAK FINANCIAL STRUCTURE THREATENS COMPETITION 10 (1991).

The following acquisitions of airlines and major airline properties, exceeding \$13 billion, were consummated since 1986:

ACQUIRED AIRLINE PROPERTIES	ACQUIRING AIRLINE	PRICE (in millions)
1986		
Pan Am (transpacific)	United	\$715
Republic	Northwest	\$884
Ozark	TWA	\$250
Eastern	Texas Air	\$676
People Express	Texas Air	\$112
1987		
Air Cal	American	\$225
Western	Delta	\$860
Pacific Southwest	USAir	\$400
Piedmont	USAir	\$1,590
1988		
TWA	Carl Icahn	unknown
1989		
Eastern (NY shuttle)	Trump	\$365
Northwest	Checchi Group	\$3,650
Eastern (Philadelphia)	Midway	\$210
1990		
Midway (Philadelphia)	USAir	\$68
Eastern (Latin America)	American	\$471
Eastern (LaGuardia slots)	American	\$10
Eastern (Canadian routes)	American	\$10
Continental (Seattle-Tokyo)	American	\$150
TWA (Chicago)	American	\$80
TWA (D.C. slots)	United	\$19
Pan Am (London)	United	\$400
Pan Am (Berlin)	Lufthansa	\$150
1991		
Midway (21 Chicago gates)	Northwest	\$22
Eastern (Chicago & D.C. gates & slots)	United	\$90
Eastern (LaGuardia gates & slots)	Continental	\$54
Eastern (Canadian routes)	Delta	\$243
Eastern (Atlanta and L.A. gates)	Delta	\$63
Pan Am (European routes and NY shuttle)	Delta	\$416
Pan Am (NY shuttle)	Delta	\$113
Pan Am (Latin America)	United	\$135
Air Wisconsin	United	\$72
Pan Am Express	TWA	\$28
TWA (Heathrow)	American	\$515

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TWA (Philadelphia and Baltimore -- London)	USAir	\$50
Continental (Air Micronesia)	investment group	\$250
<hr/>		
1992		
Continental (LaGuardia terminal and slots)	USAir	\$61

#### F. COMPUTER RESERVATIONS SYSTEMS

Ninety-five percent of travel agents use one of the airline-owned computer reservations systems [CRS].<sup>244</sup> According to the GAO, an airline which owns its own CRS stands between a 13% to 18% greater chance of selling its product through its system than does a competitor.<sup>245</sup>

Covia (owned by United, USAir and British Air) operates and markets the Apollo CRS, developed by United Air Lines. American Airlines owns Sabre.<sup>246</sup> Worldspan is owned by TWA, Northwest and Delta. It includes the Pars CRS, developed by TWA, and Datas II, developed by Delta.<sup>247</sup> System One was developed by Eastern, and acquired by Continental.

Several smaller systems exist. Abacus is owned jointly by several airlines, including Singapore Airlines and Cathay Pacific. Gemini is owned by Air Canada and Canadian.<sup>248</sup>

Sixty-six percent of all revenue booked by travel agents in the United States are booked on either Apollo or Sabre. United and American earn more than \$300 million per year from

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<sup>244</sup> GAO, AIRLINE COMPETITION; HIGHER FARES AND REDUCED COMPETITION AT CONCENTRATED AIRPORTS 27 (1990).

<sup>245</sup> GAO, AIRLINE COMPETITION: IMPACT OF COMPUTERIZED RESERVATIONS SYSTEMS (1986).

<sup>246</sup> Amadeus, Sabre Sign Long-Term Marketing Agreement, AVIATION DAILY (Nov. 19, 1990), at 334. In 1990, Sabre signed a marketing agreement with the European CRS Amadeus, which is a consortium owned equally by Lufthansa, Iberia, SAS and Air France in 1987. However, the agreement was not consummated.

<sup>247</sup> System One, Continental Optimistic About Deal with Worldspan, AVIATION DAILY (Mar. 20, 1991), at S17.

<sup>248</sup> The Financial Condition of the Airline Industry and the Adequacy of Competition, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. 489 (1991) (statement of Helane Becker).

weaker airlines beyond the cost of providing the service, according to the GAO.<sup>249</sup> The DOT has concluded that booking fees charged other airlines were approximately double American's or United's average costs in 1988.<sup>250</sup> These carriers enjoy rates of return on their CRSs of between 60% to 100% a year.<sup>251</sup> Critics have asserted that this gives American Airlines fees in excess of costs approximately \$215 million a year, and an advantage of \$328 million a year as a result of the "halo" effect.<sup>252</sup> An airline which owns a CRS stands between a 13% to 18% greater chance of selling its product through its system than does a competitor. American responds by insisting that Sabre's annual profits are only about \$78 million, and it pays some \$57 in booking fees to other CRS vendors.<sup>253</sup> Some have also alleged that computer reservations systems facilitate implicit price fixing.<sup>254</sup>

#### G. DEBT

Anemic profitability in the 1980s coupled with leveraged buy-outs caused a number of airlines to increase their debt-to-equity ratios.

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<sup>249</sup> Intelligence, AVIATION DAILY (Feb. 11, 1991), at 269.

<sup>250</sup> The Financial Condition of the Airline Industry and the Adequacy of Competition, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. XVII (1991). DOT, STUDY OF COMPUTER AIRLINE RESERVATIONS SYSTEMS 110 (1988).

<sup>251</sup> The Financial Condition of the Airline Industry and the Adequacy of Competition, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. XVIII (1991).

<sup>252</sup> The Financial Condition of the Airline Industry and the Adequacy of Competition, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. 65 (1991) (statement of Edward R. Beauvais).

<sup>253</sup> The Financial Condition of the Airline Industry and the Adequacy of Competition, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. 595 (1991) (statement of William J. Burhop).

<sup>254</sup> See Nomani, Fare Warning: How Airlines Trade Price Plans, Wall St. J., Oct. 9, 1990, at B1.

LONG-TERM DEBT AS A PERCENTAGE OF CAPITALIZATION<sup>255</sup>

AIRLINE	1980	1983	1986	1989
America West	--	44.7	81.5	84.5
American	63.4	51.2	45.1	33.5
Continental	62.3	308.9	97.3	96.3
Delta	10.6	45.0	33.4	18.3
Eastern	78.5	93.2	90.7	n.a.
Northwest	5.4	8.2	50.8	n.a.
Pan Am	62.0	71.9	99.0	272.9
Southwest	38.0	29.6	35.3	33.4
TWA	61.8	65.4	94.2	114.8
United	45.2	41.5	45.8	46.1
USAir	44.0	31.8	24.8	44.8
INDUSTRY AVERAGE	53.5	57.3	56.8	56.2

In addition, the heavily leveraged airline industry carries considerable debt off its balance sheets in the form of sales of residual aircraft values (the estimated value of the aircraft at the end of the lease term), while leasing back the planes.<sup>256</sup> For example, adding the debt equivalent of aircraft leases to Delta's on balance sheet debt (about \$3 billion to the on balance sheet debt of \$1.2 billion), increases the debt-to-equity ratio to 61%.<sup>257</sup> About fifty percent of the aircraft in the U.S. fleet are owned and leased by equipment leasing companies.<sup>258</sup> Moreover, frequent flyer liability, totaling more than \$100 million at some airlines, is also omitted from the balance sheets.

<sup>255</sup> See *The Financial Condition of the Airline Industry and the Adequacy of Competition*, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. 570 (1991) (statement of Kenneth Mead); *AVIATION DAILY* (Feb. 13, 1991), at 297.

<sup>256</sup> *The Financial Condition of the Airline Industry and the Adequacy of Competition*, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. 589-90 (1991) (statement of Timothy Petree).

<sup>257</sup> Hearings on Leveraged Buyouts and Foreign Ownership of United States Airlines Before the Aviation Subcomm. of the House Comm. on Public Works and Transp., 101st Cong., 1st Sess. 3 (1989) (statement of Philip Baggaley).

<sup>258</sup> Aircraft Lessors Concerned About Stage 2 Phaseout, *AVIATION DAILY* (Oct. 10, 1991), at 69.

## H. ECONOMIC PERFORMANCE

Worldwide, civil aviation generates gross revenue of some \$700 million.<sup>259</sup> In the United States, airlines and airports produce gross revenue of \$254 billion.<sup>260</sup> Commercial air transportation is an integral part of the tour and travel industry, arguably the world's largest single industry, creating revenue of \$2.5 trillion, about 5.5% of the world's GNPs.<sup>261</sup>

During the first decade of deregulation, the U.S. airline industry's profit margin declined 74%, from already unsatisfactory levels, to a paltry 0.6% (compared with between 3.0% and 6.0% for all manufacturers).<sup>262</sup> The following chart reveals profit margins in the airline industry pre- and post-deregulation:

NET PROFIT MARGIN OF U.S. SCHEDULED PASSENGER AIRLINES<sup>263</sup>

Year	Return on Investment	Net Profit	Profit Margin
1955	11.8%		5.6%
1956	9.4		4.6
1957	4.9		1.9
1958	6.3		3.0
1959	7.3		3.4
1960	2.8		0
1961	1.5		(1.7)
1962	4.1		0.4
1963	4.3		0.5
1964	10.0		4.8
1965	11.2		6.8
1966	9.7		6.5
1967	6.9		5.5
1968	4.9		2.5
1969	4.3		1.8
1970	1.4		(1.6)
1971	3.3	\$ (3)	0
1972	5.1	277	2.5

<sup>259</sup> Eser, *Airlines Bleeding to Death*, *IATA REVIEW* (Apr. 1991), at 3.

<sup>260</sup> TRANSPORTATION RESEARCH BOARD, *WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION* 21 (1991).

<sup>261</sup> Eser, *Airlines Bleeding to Death*, *IATA REVIEW* (Apr. 1991), at 3.

<sup>262</sup> US Airline Deregulation a Financial Disaster, AFN Study Shows, *COMMUTER REGIONAL AIRLINE NEWS* (Apr. 8, 1991), at 8.

<sup>263</sup> 1955-70: Brenner, Need for Continued Economic Regulation of Air Transport, 41 J. AIR L. & COM. 793, 810 (1975). 1971-78: Brenner, *Airline Deregulation — A Case Study in Public Policy Failure*, 16 TRANSP. L.J. 179, 202 (1988). 1979-89: M. Brenner, *Analysis of Airline Concentration Issue* 84 (unpublished monograph, 1990).

1973	4.7	217	1.8
1974	7.8	306	2.1
1975		(274)	(1.8)
1976		351	2.0
1977		535	2.7
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1978		826	3.6
1979		347	1.3
1980		17	0.1
1981		(301)	(0.8)
1982		(916)	(2.5)
1983		(189)	(0.5)
1984		825	1.9
1985		863	1.8
1986		(235)	(0.5)
1987		593	1.0
1988		1,706	2.6
1989		190	0.3

The two year period ending June 30, 1989, was the most profitable period in airline history.<sup>264</sup> But profitability turned south in 1990, when the domestic airline industry suffered an unprecedented net loss of \$3.9 billion in 1990 — the worst losses in its history. U.S. airlines lost another \$1.8 billion in 1991.<sup>265</sup> The world's commercial airlines lost \$2.7 billion in 1990 and \$4 billion in 1991 on international routes alone.<sup>266</sup>

By the end of 1991, the U.S. airline industry had lost all the profit it had earned since the Wright Brothers flew at Kitty Hawk, plus nearly \$2 billion more.<sup>267</sup> It was predicted that the industry would earn only \$300 million in 1992, representing a profit margin of only 0.3%.<sup>268</sup> The net cumulative earnings of the U.S. airline industry is reflected in the following chart.

<sup>264</sup> Hearings on Leveraged Buyouts and Foreign Ownership of United States Airlines Before the Aviation Subcomm. of the House Comm. on Public Works and Transp., 101st Cong., 1st Sess. 14 (1989) (statement of Timothy Pettee).

<sup>265</sup> McGinley, Airline Industry Seen Posting Losses in Fourth Quarter, Wall St. J., Oct. 8, 1991, at A16. Few Bright Spots in 1991 for U.S. Carriers, AVIATION DAILY (Dec. 16, 1991), at 466; U.S. Airlines Will Lose Another \$1.8 Billion in 1991, AVIATION DAILY (Dec. 10, 1991), at 429.

<sup>266</sup> Will They Ever Fly Again?, THE ECONOMIST (Mar. 7, 1992), at 67.

<sup>267</sup> Almost One in 10 Airline Workers Loses Job; Financial Losses Exceed Gains, AVIATION DAILY (Oct. 29, 1991), at 177.

<sup>268</sup> McGinley, Airline Industry Seen Posting Losses in Fourth Quarter, Wall St. J., Oct. 8, 1991, at A16.

CUMULATIVE AIRLINE EARNINGS<sup>269</sup>  
(in million \$)

YEAR	NET PROFIT (LOSS)
1981	3,499.2
1982	2,749.6
1983	2,474.3
1984	3,058.5
1985	3,894.9
1986	3,321.2
1987	4,176.0
1988	4,744.2
1989	3,267.8
1990	(470.4)
1991	(1,800.0)*

\* 1991 estimate

Anemic economic performance has forced nearly 200 airlines into bankruptcy since deregulation began in 1978. Some enter Chapter 11 reorganization bankruptcy, continuing operations while seeking to restructure debt. Because they are shielded from their creditors while in Chapter 11, many "trash" the fares in the markets in which they compete, much to the chagrin of carriers operating outside of Chapter 11. Executives at both American and Delta have urged the DOT to revoke the certificates of airlines in bankruptcy on grounds that they fail to satisfy the fitness obligations of the Federal Aviation Act.<sup>270</sup>

The airline industry has placed approximately \$80 billion in orders for new aircraft -- two to three times the total invested capital in the industry.<sup>271</sup> The industry needs to raise between \$130 billion and \$200 billion by the end of the decade for new aircraft (investing between \$15 billion and \$20 billion annually), and another \$50 billion for airport and

<sup>269</sup> Cumulative Airline Earnings, AVIATION DAILY (Oct. 29, 1991), at 177; updated by U.S. Airlines Will Lose Another \$1.8 Billion in 1991, AVIATION DAILY (Dec. 10, 1991), at 429.

<sup>270</sup> Delta Executive Echoes Crandall Remarks On Bankrupt Airlines, AVIATION DAILY (Feb. 19, 1992), at 296.

<sup>271</sup> The Financial Condition of the Airline Industry and the Adequacy of Competition, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. 589 (1991) (statement of Timothy Petree).

infrastructure improvements.<sup>272</sup> Bear in mind that the airline industry as a whole had operating cash of less than \$5 billion and operating earnings of \$2.3 billion in 1988, which was a very good year.<sup>273</sup> Excessive debt can have a debilitating effect on the ability of airlines to make new aircraft purchases, expand operations, maintain competition, or withstand the vicissitudes of the market cycle.

#### I. EMPLOYMENT

Worldwide, civil aviation employs 21 million people.<sup>274</sup> In the United States, more than 2 million Americans are employed in airline or airport operations.<sup>275</sup> Commercial air transportation is an integral part of the tour and travel industry, arguably the world's largest single industry, employing 112 million people.<sup>276</sup> During 1990-1991, about 55,000 U.S. and Canadian airline employees, or nearly one in ten workers in this industry, lost their jobs.<sup>277</sup>

#### J. EXPENSES

The airline's operating expenses increased 94% during deregulation's first six years.<sup>278</sup> The following changes have occurred in selected expenses as a percentage of total operating expenses from 1980 to 1990:

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<sup>272</sup> McGinley, Airline Industry Seen Posting Losses in Fourth Quarter, *Wall St. J.*, Oct. 8, 1991, at A16; U.S. Airlines Will Lose Another \$1.8 Billion in 1991, *AVIATION DAILY* (Dec. 10, 1991), at 429.

<sup>273</sup> Hearings on Leveraged Buyouts and Foreign Ownership of United States Airlines Before the Aviation Subcomm. of the House Comn. on Public Works and Transp., 101st Cong., 1st Sess. 3 (1989) (statement of Philip Baggaley); *Id.* at 73 (statement of Timothy Pettee).

<sup>274</sup> Eser, Airlines Bleeding to Death, *IATA REVIEW* (Apr. 1991), at 3.

<sup>275</sup> TRANSPORTATION RESEARCH BOARD, *WINDS OF CHANGE: DOMESTIC AIR TRANSPORT SINCE DEREGULATION* 21 (1991).

<sup>276</sup> Eser, Airlines Bleeding to Death, *IATA REVIEW* (Apr. 1991), at 3.

<sup>277</sup> Almost One in 10 Airline Workers Loses Job; Financial Losses Exceed Gains, *AVIATION DAILY* (Oct. 29, 1991), at 177, updated by the demise of Pan Am in December, 1991.

<sup>278</sup> GAO, *COMPETITION: HIGHER FARES AND REDUCED COMPETITION AT CONCENTRATED AIRPORTS* 24 (1990).

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BREAKDOWN OF OPERATING EXPENSES (1980-1990) <sup>279</sup>		1980	1990
EXPENSE			
Labor Salaries and Benefits		37.3%	33.8%
Aircraft Fuel and Oil		31.0%	17.7%
Travel Agent Commissions		3.4%	10.0%
Equipment Rentals		1.8%	7.1%
Landing Fees		1.7%	1.8%
Advertising and Other Promotions		1.7%	2.1%
All Other (e.g. maintenance, food, interest)		21.1%	27.2%

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Note that the fastest growing costs during this period were equipment rentals (increasing 781% over this period), and travel agent commissions (rising 308%).<sup>280</sup> Today, 45% of the U.S. fleet is leased.<sup>281</sup> Contrary to the assertions of former U.S. Secretary of Transportation Samuel Skinner, labor costs were not responsible for the disintegration of the economic health of U.S. airlines. As a percentage of operating expenses, labor costs declined during this period.

Every cent a gallon increase in jet fuel costs the industry about \$150 million.<sup>282</sup> Much of the industry's economic anemia occurring in 1990-91 was blamed in the spike in fuel costs precipitated by Operation Desert Storm. Actually, aviation fuel cost more per gallon between 1981 and 1984 (when it ranged between \$0.79 and \$1.04 per gallon, or adjusted for inflation, between \$1.40 and \$1.47), than in 1990 (when it sold for only \$0.80 per gallon).<sup>283</sup> Fuel costs dropped 31% between 1985 and 1986.<sup>284</sup> By December 1991, the spot price of aviation fuel was just \$0.47 per gallon.<sup>285</sup>

<sup>279</sup> Comparison of Selected Airline Industry Expenses, AVIATION DAILY (July 29, 1991), at 176.

<sup>280</sup> Salaries Have Doubled Since 1980; Other Expenses Grew Faster, AVIATION DAILY (July 29, 1991), at

<sup>281</sup> Aircraft Leasing Firms Seek to Protect Assets, AVIATION DAILY (Apr. 22, 1991), at 147.

<sup>282</sup> Plummeting Jet Fuel Prices to Have Little Effect on Air Ticket Prices, AVIATION DAILY (Dec. 30, 1991), at 545.

<sup>283</sup> Flint, Don't Blame It All On Fuel, AIR TRANSPORT WORLD (Feb. 1991), at 32.

<sup>284</sup> Id.

<sup>285</sup> Plummeting Jet Fuel Prices to Have Little Effect on Air Ticket Prices, AVIATION DAILY (Dec. 30, 1991), at 545.

## K. INTERNATIONAL AVIATION

The economic well being of some airlines appears to be driven by disproportionate profits earned on international routes. For example, between 1987 and 1989, Northwest earned between 68% and 91% of its total operating profit from international markets, while United earned between 24% and 34% from its international routes.<sup>286</sup>

The following chart identifies the source of foreign tourists in the United States.

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TOP TEN TOURIST GENERATING NATIONS<sup>287</sup>  
(January-May, 1991)

COUNTRY OF RESIDENCE	NUMBER OF ARRIVALS	PERCENTAGE OF TOTAL
Canada	6,712,141	53.1
Japan	1,087,298	8.6
United Kingdom	847,244	6.7
Germany	488,452	3.8
Mexico	469,811	3.7
France	271,080	2.1
Australia	166,373	1.3
Brazil	156,342	1.2
Italy	130,193	1.0
China	114,177	0.9

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Of course, not all tourists fly. Many from Canada or Mexico drive their automobiles. A better indication of the nations which are responsible for generating the largest number of airline passengers is provided by the following chart:

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TOP TEN NATIONS GENERATING AIRLINE  
PASSENGER TRAFFIC TO AND FROM THE UNITED STATES (1989)<sup>288</sup>

COUNTRY	TOTAL TRAFFIC (000)	% U.S. CITIZENS	% U.S. FLAG
United Kingdom	9,166	50	51
Japan	8,199	24	55
Mexico	7,473	72	55

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<sup>286</sup> M. Jedel, Post Deregulation Strategic Employment Relations Response of the Successful, *Surviving Major Domestic Airlines: A Story Not Fully Told* 42 (unpublished monograph, 1991).

<sup>287</sup> Data shown are from January to May, 1991. Tourist Travel Rebounds in 2d Quarter 1991, Spending Also Up, *AVIATION DAILY* (Sept. 24, 1991), at 561.

<sup>288</sup> Passenger Traffic to and from the U.S. and Other Countries, *AVIATION DAILY* (July 18, 1990), at 112.

Germany	4,199	57	51
France	3,064	55	64
Bahama Islands	2,855	75	74
Dominican Republic	1,772	77	77
Jamaica	1,697	72	38
Netherlands	1,467	49	14
Italy	1,440	62	54

Forty-four million people will visit the United States in 1992.<sup>289</sup> Brazil is expected to have the strongest growth in visitors to the United States in 1992, with traffic increasing 14%, followed by Italy (12%) and France (8%).<sup>290</sup> Foreign travel to the U.S. increased by 67% between 1986 and 1991, while U.S. travel abroad rose only 23%.<sup>291</sup> Some 30% of U.S. citizens were expected to travel abroad in 1992, with the most likely group between 45 and 49 years old and family income of more than \$40,000 a year.<sup>292</sup>

The following chart identifies the largest foreign airlines.

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**TEN LARGEST FOREIGN AIRLINES<sup>293</sup>**  
(first half, 1989)

AIRLINE	PASSENGERS	REVENUE PASSENGER KM
British Airways	12,160,847	31,610,696
Lufthansa	10,462,100	19,335,800
Air France	17,462,529	17,462,529
Singapore Airlines	3,407,000	15,232,600
Qantas Airways	2,061,927	13,548,823
KLM Royal Dutch Airlines	3,523,888	12,422,988
Canadian Airlines Int'l	4,806,322	11,792,132
Iberia Airlines	7,513,147	10,257,747
SAS	7,321,000	7,943,000
Swissair	7,765,844	7,765,844

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In recent years, foreign airlines have purchased major equity interest in U.S. flag carriers.

<sup>289</sup> U.S. Travel Industry Encouraged by Influx of Foreign Visitors, AVIATION DAILY (Oct. 29, 1991), at 180.

<sup>290</sup> Intelligence, AVIATION DAILY (Oct. 28, 1991), at 167.

<sup>291</sup> *Id.*

<sup>292</sup> Thirty Percent of U.S. adults to Travel Internationally by 1992, AVIATION DAILY (Feb. 21, 1992), at 317.

<sup>293</sup> International Carriers Traffic, AVIATION DAILY (Jan. 7, 1990), at 36.

FOREIGN AIRLINE OWNERSHIP OF U.S. AIRLINES		
Foreign Airline	Percentage Ownership	U.S. Airline
SAS	18.4%	Continental
Swissair	5%	Delta
Singapore Airlines	5%	Delta
Ansett Airlines	17%	America West
Japan Air Lines	20%	Hawaiian Airlines
KLM	49%	Northwest
British Air	15%*	United
* proposed; later withdrawn		

Foreign equity alliances have also proliferated, as revealed by the following chart.

CROSS OWNERSHIP AGREEMENTS BETWEEN FOREIGN AIRLINES 294

Purchaser	Percentage Ownership	Target
Air France	1.5%	Austrian Airlines
Air France	71%	UTA
Air France	37%	Air Inter
Air France	2%	Austrian Airlines
American	8%	Air New Zealand
ANA	10%	Austrian Airlines
Cathay Pacific	35%	Dragonair
Delta	3%	Singapore Airlines
Delta	5%	Swissair
Iberia	85%	Aerolineas Argentinas
Japan Air Lines	8%	Air New Zealand
KLM	15%	Air UK
Qantas	20%	Air New Zealand
SAS	5%	Swissair
SAS	35%	Lan Chile
SAS	25%	Airlines of Britain
SAS	16%	CTA
Singapore	3%	Swissair
Swissair	10%	Austrian Airlines
Swissair	5%	SAS

294 Testimony of Helane Becker (vice president, Lehman Brothers) Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation (Feb. 6, 1991), at 5. Going Steady, ECONOMIST (July 22, 1989), at 39; and Overlapping Airlines: Recent Investments, Wall St. J., July 23, 1991, at A6.

## L. PENSION LIABILITY

Several airlines have seriously unfunded pension plans. TWA's pensions were unfunded by \$190 million in 1990, \$440 million in 1991, and \$933 million in 1992.<sup>295</sup> Concern over Carl Icahn's privatization of TWA, and the potential that the taxpayer might be stuck with paying its unfunded pension liability led Congress to pass legislation making Mr. Icahn personally responsible for the bill.<sup>296</sup> In 1990, United's pension was unfunded by \$57 million; Northwest's was unfunded by \$78 million.<sup>297</sup> Continental's was unfunded by \$183 million, and the Pension Benefit Guarantee Corporation [PBGC] filed a claim in Continental's bankruptcy seeking to recover \$752 million in unfunded Eastern Air Lines liability.<sup>298</sup>

Several carriers which have ceased operating left the PBGC holding the bag. These included Pan Am (\$914 million unfunded), and as noted above, Eastern (\$752 million unfunded).<sup>299</sup> It has been predicted that unfunded pension plans left high and dry by the disintegration of airlines may ultimately cost the U.S. taxpayer \$1.7 billion.<sup>300</sup>

In January 1992, the Pension Benefit Guaranty Corporation filed to block Continental's \$290 million sale of Air Micronesia to an investor group on grounds that Continental Airline Holdings owes approximately \$700 million in unfunded pension liability.<sup>301</sup>

<sup>295</sup> Three Majors Among Top 50 Firms With Unfunded Pensions, AVIATION DAILY (Nov. 26, 1991), at 355; TWA Surprises Industry With Early Chapter 11 Bankruptcy Filing, AVIATION DAILY (Feb. 3, 1992), at 199.

<sup>296</sup> Bill Binding TWA Chairman to Pensions Passed in Congress, AVIATION DAILY (Dec. 2, 1991), at 372.

<sup>297</sup> Three Majors Among Top 50 Firms With Unfunded Pensions, AVIATION DAILY (Nov. 26, 1991), at 355.

<sup>298</sup> Continental Withholds \$17 Million Pension Payment, AVIATION DAILY (Oct. 10, 1991), at 67.

<sup>299</sup> Three Majors Among Top 50 Firms With Unfunded Pensions, AVIATION DAILY (Nov. 26, 1991), at 355.

<sup>300</sup> Airline Financial Woes Trigger Pension Underfunding Crisis, AVIATION DAILY (Feb. 21, 1991), at 339.

<sup>301</sup> PBGC Moves to Block Sale of Continental's Stake in Air Micronesia, AVIATION DAILY (Jan. 23, 1992), at 139.

## M. PRICING

By the end of the first decade of deregulation, the full unrestricted "Y" fare had increased 156%, double the inflation rate.<sup>302</sup> With the full fare rising so sharply, relatively few passengers would pay it. During 1991, 95% of all passengers were flying on a discount, with the average discount some 66% off the full fare.<sup>303</sup>

Discounted fares are targeted at discretionary (vacation) travelers. So as to dissuade business travelers from using them, they ordinarily come saddled with restrictions -- nonrefundability, advance purchase requirements, and Saturday night stay over obligations. However, large corporations can often negotiate a contract rate with airlines which includes the discounted fares, but is largely devoid of restrictions.<sup>304</sup>

Air fares at small and medium sized communities are nine percent higher, on average, than at large communities.<sup>305</sup> And, as noted above, fares are some 27% higher for trips beginning or ending at concentrated hub airports.<sup>306</sup> Fares in monopoly markets (about 10% of the total markets), are about 10% higher than competitive markets.<sup>307</sup> In 1992, the U.S. Department of Justice launched an antitrust investigation of the airline industry for allegedly engaging in price fixing.<sup>308</sup> An American Airlines vice president colorfully rebutted the contention of monopolization, saying, "We're obviously not enjoying monopoly prices because we're all losing our butts."<sup>309</sup>

<sup>302</sup> Ott, Industry Officials Praise Deregulation, But Cite Flaws, AV. WEEK & SPACE TECH. (Oct. 31, 1988), at 88.

<sup>303</sup> Few Bright Spots in 1991 for U.S. Carriers (Dec. 16, 1991), at 466.

<sup>304</sup> See Business and the Airlines Play Let's Make a Deal, BUS. WEEK (Mar. 4, 1991), at 54.

<sup>305</sup> Fares at Smaller Airports Show Greatest Drop Since 1978, AVIATION DAILY (Dec. 18, 1990), at \$20.

<sup>306</sup> GAO, AIR FARES AND SERVICE AT CONCENTRATED AIRPORTS (1989).

<sup>307</sup> The Financial Condition of the Airline Industry and the Adequacy of Competition, Hearings Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation, 102nd Cong., 2d Sess. VII (1991).

<sup>308</sup> Noman, U.S. Steps Up Probe on Fixing of Air Fares, Wall St. J., Mar. 18, 1992, at A3.

<sup>309</sup> O'Brian, Airlines Seek to Earn More From an Irritated Clientele, Wall St. J., Mar. 16, 1992, at B1, B10. See Noman, Airlines Claim Inquiry on Fares Is Unwarranted, Wall St. J., Mar. 19, 1992, at A3.

In 1992, American Airlines led a rate rationalization attempt which significantly reduced the number of fare categories, lowering the highest fares and raising the lowest fares. The new simplified rate structure would allegedly be easier for consumers to understand. It would also allow American to reduce the number of its employees devoted to yield management. Also, rate simplification might enable the industry eventually to roll back travel agent commissions, which have been the second largest increasing item of operating expenses. Critics charged that the fares might drive some of the airlines in Chapter 11 into the abyss of liquidation.

At any given time, consumers hold some \$3.5 billion in prepaid tickets.<sup>310</sup> Hence, bankruptcies can leave many travelers stranded, literally and financially.

#### N. PUBLIC EXPENDITURES

In 1991, the state of Minnesota gave an incentive package worth \$838 million to Northwest Airlines to build an aircraft maintenance complex in the state.<sup>311</sup> Included was \$320 million in low-interest loans provided by the Metropolitan Airports Commission, operator of the Minneapolis/St. Paul Airport, as well as \$350 million in bonds to construct the complex. The complex was expected to add approximately 1,900 new jobs to the state, on top of the 18,000 Northwest already employed in Minnesota.<sup>312</sup>

A study performed by the European Community Commission conservatively estimated that the U.S. government gave the airline industry between \$33.5 billion and \$41.5 billion in direct and indirect support from the mid-1970s to present.<sup>313</sup> The investment includes between \$12.4 billion and \$20.2 billion in aeronautics R&D from the U.S. Defense Department, between \$1 billion and \$1.2 billion in independent R&D reimbursed by the U.S.

<sup>310</sup> Intelligence, *AVIATION DAILY* (Feb. 25, 1991), at 359.

<sup>311</sup> Minnesota Legislature Gives Final Approval to Northwest Incentive Package, *AVIATION DAILY* (Dec. 17, 1991), at 474.

<sup>312</sup> *Id.*

<sup>313</sup> EC Study: U.S. Gave Up to \$41.5 Billion to Aircraft Industry, *AVIATION DAILY* (Dec. 5, 1991), at 401.

Department of Defense [DOD], and \$17 billion from NASA programs. It also estimated that total tax deferrals and exemptions granted the industry have exceeded some \$3.5 billion since 1976.<sup>314</sup>

One criticism which has been levied at the U.S. Department of Transportation is that while it has accumulated some \$16 billion dollars in the Airport and Airway Trust Fund,<sup>315</sup> it refuses to spend it, preferring instead to use it to offset a \$15 billion piece of the \$3 trillion U.S. budget deficit.

#### O. PUBLIC OPINION

In 1978, various public opinion polls revealed that airlines ranked at the very top of all industries in terms of consumer confidence and satisfaction.<sup>316</sup> But in 1989, when the Wall Street Journal polled Americans to discern the industries in which they had most, and least, confidence, the largest number by far, 43%, said they had no confidence in the airline industry.<sup>317</sup> The disapproval ratings for the industries which followed -- insurance (27%), banking (23%), oil and gas (22%), and stockbrokers (22%) -- was not nearly as high as that for airlines.<sup>318</sup>

The following chart reveals the comparative rankings of major airlines on the basis of consumer complaints filed with the DOT.

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<sup>314</sup> EC Study: U.S. Gave Up to \$41.5 Billion to Aircraft Industry, AVIATION DAILY (Dec. 5, 1991), at 401.

<sup>315</sup> See AVIATION DAILY (Jan. 2, 1992), at 7; AVIATION DAILY (Apr. 26, 1991), at 190; AVIATION DAILY (Jan. 24, 1991), at 159; AVIATION DAILY (Aug. 17, 1990), at 248.

<sup>316</sup> Callison, Airline Deregulation -- Only Partially a Hoax: The Current Status of the Airline Deregulation Movement, 45 J. AIR L. & COM. 961, 964 n. 4 (1980), citing 236 AVIATION DAILY 118 (1978).

<sup>318</sup> Winans and Dahl, Airlines Skid on Bad Moves, Bad News, Wall St. J., Sept 29, 1989, at B1.  
<sup>318</sup> Id.

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CONSUMER COMPLAINTS AGAINST MAJOR U.S. AIRLINES<sup>319</sup>  
(per 100,000 passengers)

AIRLINE	JANUARY 1989	JANUARY 1990	JANUARY 1991
America West	3.98	2.10	2.82
American	1.82	0.97	2.47
Continental	4.99	3.75	1.47
Delta	0.97	0.61	0.54
Eastern	4.06	4.72	N/A
Northwest	2.54	2.09	1.61
Pan Am	5.23	6.98	3.99
Southwest	0.81	0.58	0.68
TWA	5.48	7.80	7.19
United	2.63	1.74	1.77
USAir	2.39	4.29	0.67
AVERAGE	2.74	2.64	1.91

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The following chart breaks down consumer complaints by type.

CONSUMER COMPLAINTS BY CATEGORY <sup>320</sup>		PERCENTAGE OF TOTAL NOV. 1988	NOV. 1989
PROBLEM			
Flight Problems	32.8	37.5	
Baggage	18.3	17.6	
Refunds	7.8	11.3	
Customer Service	10.8	9.6	
Reservations, Ticketing, Boarding	7.2	8.8	
Oversales	5.7	4.2	
Fares	2.2	2.6	
Smoking	3.2	1.8	
Advertising	0.6	1.5	
Tours	.0	0.3	
Credit	.0	0.1	
Other	10.9	4.2	

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Still another measure of service is on-time arrival, skewed somewhat because of the way in which DOT measures it (e.g., a flight must be more than 15 minutes late to be considered late):

<sup>319</sup> Rankings of U.S. Carriers Consumer Complaints Per 100,000 Passengers, AVIATION DAILY (Mar. 8, 1990); Rankings of U.S. Carriers Consumer Complaints, AVIATION DAILY (Mar. 8, 1991), at 454.

<sup>320</sup> Consumer Complaints Against U.S. Carriers Reported to Dot by Category, AVIATION DAILY (Jan. 10, 1990), at 70.

ON TIME ARRIVALS, BY CARRIERS<sup>321</sup>  
(Sept 1987 - Aug 1991)

Rank	Airline	Percentage On Time
1.	America West	84.1
2.	Southwest	82.3
3.	Midway	81.5
4.	American	81.3
5.	Alaska	80.1
6.	Northwest	79.8
7.	Eastern	79.5
8.	Delta	78.7
9.	Pan Am	78.6
10.	Continental	78.4
11.	USAir	78.0
12.	TWA	76.8
13.	United	75.7
AVERAGE		78.8

The American Automobile Association surveyed Americans to identify their principal concerns. Dubbed the "Hassle Index", it found that 23% said the cost of air service was their principal concern (only 7% said that in 1990). Safety rated second at 22%, while 10% were concerned about the condition of the aircraft, and 8% with traffic congestion. Forty-two percent believed that fares became worse during 1991 (compared with 34% in 1990).<sup>322</sup>

A poll conducted in late 1992 by the Roper Organization revealed that 37% approved of the current level of government regulation of fares and service, while 33% thought there was not enough; 51% of Americans believe that safety regulation is not strong enough, while 21% believe that safety regulation is sufficient.<sup>323</sup>

<sup>321</sup> Overall Percentages of Reported Domestic Flights Arriving On Time, By Carrier, AVIATION DAILY (Oct. 9, 1991), at 63.

<sup>322</sup> Cost of Air Travel Replaces Safety As Main Concern to Travelers, AVIATION DAILY (Jan. 7, 1992), at 28.

<sup>323</sup> Union Releases Survey on Deregulation With Mixed Findings, AVIATION DAILY (Nov. 25, 1991), at 342.

## P. SAFETY

Fatality rates suggest air travel is among the safest modes of transportation -- 19 times safer than traveling by automobile. Between 1975 and 1989, the risk of death was only one in 10 million.<sup>324</sup>

Although the long-term accident and fatality trend declined both before and after deregulation, the accident experience of U.S. passenger carriers became worse in the second half of the 1980s.<sup>325</sup> In 1989, the industry suffered the highest number of fatal accidents since 1968.<sup>326</sup>

More recently, the fatality and accident picture has improved. The U.S. commercial airline industry had but two fatal accidents in 1991, and six the previous year.<sup>327</sup>

However, the commuter industry's safety record in the post-deregulation period is about four times worse than that of the large commercial carriers.<sup>328</sup> In 1991 commuter passenger fatalities reached their highest level since the NTSB began tracking it in 1977.<sup>329</sup> In fact, the fatality accident rate was higher for commuter airlines using aircraft with 30 or fewer seats than the major carriers for every year during the 1980s.<sup>330</sup>

Some have argued that, under deregulation, economics drives the safety margin as they do all costs. In 1991, several former Eastern Airline employees were indicted by a Brooklyn grand jury on charges that they deliberately falsified maintenance logs and failed to perform

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<sup>324</sup> Nazario & Wartzman, Bungled Evacuation Test Raises Concern About Stuffing More Seats Into Airplanes, *Wall St. J.*, Nov. 1, 1991, at B1.

<sup>325</sup> Bruggink, U.S. Aviation Accidents and Deregulation, *AIR LINE PILOT* (Mar. 1991), at 20, 24.

<sup>326</sup> Fatal Accidents Highest Since 1968, *Safety Board Reports*, *AVIATION DAILY* (Jan. 18, 1990), at 122.

<sup>327</sup> Few Bright Spots in 1991 for U.S. Carriers, *AVIATION DAILY* (Dec. 16, 1991), at 466.

<sup>328</sup> Bruggink, U.S. Aviation Accidents and Deregulation, *AIR LINE PILOT* (Mar. 1991), at 20, 23.

<sup>329</sup> McGinley, Rise in Commuter Plane Fatalities Sparks Call to Toughen Rules, Improve Training, *Wall St. J.*, Nov. 12, 1991, at B1; Year Ends With Fewest Fatal Airline Accidents Since 1986, *AVIATION DAILY* (Jan. 3, 1992), at 9.

<sup>330</sup> McGinley, Rise in Commuter Plane Fatalities Sparks Call to Toughen Rules, Improve Training, *Wall St. J.*, Nov. 12, 1991, at B1.

maintenance on critical aircraft parts including altimeters, compasses, wing flaps, cockpit landing gear lights, auto pilot systems and fuel gauges.<sup>331</sup>

#### Q. TAXES

According to the Air Transport Association, taxes rose 81% from 1981 to 1991, and cost the industry \$6 billion a year.<sup>332</sup> Among the taxes imposed on individual tickets are the following: TICKET TAX (10%); PASSENGER FACILITY CHARGES (up to \$12 per trip); CARGO WAYBILL TAX (6.25%); CUSTOM USERS FEE (\$6); IMMIGRATION USER FEE (\$5); and AGRICULTURAL PLANT/HEALTH INSPECTION SERVICE USER FEE (\$2).<sup>333</sup>

In 1990 and 1991, several airlines proposed that the U.S. government allow it to borrow the 10% ticket tax it collects from passengers, which generates about \$4 billion a year.<sup>334</sup> U.S. airlines pointed out that the government of France had provided approximately \$400 million to Air France, the Belgian government had given about \$300 million to Sabena, and the Italian government was planning to give more than \$300 million to Alitalia.<sup>335</sup>

#### R. WALL STREET STOCK VALUE

In 1990 and 1991, the stock value of all U.S. major airlines combined ranged from a low of about \$9 billion (in December 1990) to a high of \$14 billion (in May 1990, and May 1991). The value of all national airlines ranged from a low of about \$550 million (in November 1990), to a high of about \$1.2 billion (in December 1991).<sup>336</sup> The stock value of the regional airlines combined ranged from a low of \$75 million (in September 1990) to a high

<sup>331</sup> Federal, AVIATION DAILY (Mar. 11, 1991), at 457; Nine More Eastern Supervisors Charged With Falsifying Records, AVIATION DAILY (Feb. 15, 1991), at 312.

<sup>332</sup> Airlines Letting Passengers Know About Taxes, AVIATION DAILY (Dec. 16, 1991), at 467.

<sup>333</sup> *Id.*

<sup>334</sup> Nomani & McGinley, Airlines Weigh Plans to Seek Federal Help, Wall St. J., Feb. 19, 1991; Little Support Shown in Washington for Ticket Tax Proposal, AVIATION DAILY (Feb. 25, 1991), at 361.

<sup>335</sup> DOT Says 'Hands Off' Best Approach to Helping Competition, AVIATION DAILY (Mar. 6, 1991), at 427.

<sup>336</sup> Value of Airline Stocks Soar Despite Financial Losses, AVIATION DAILY (Jan. 8, 1992), at 36.

of \$187 million (in December 1991).<sup>337</sup> The stock value of the all-cargo airlines combined ranged from a low of \$1 billion (in November 1990) to a high of \$3.8 billion (in April 1990).<sup>338</sup> The combined value of all cargo and passenger airlines ranged from a high of \$18.7 billion in May 1991 to a low of \$15.6 billion in November 1991.<sup>339</sup>

#### ***IV. CABOTAGE, FOREIGN OWNERSHIP AND INTERNATIONAL AVIATION***

##### **A. Cabotage**

The legal concept of cabotage has its origin in maritime law. It is thought to have originated from either the French word "cabot," meaning a small vessel, or the Spanish word "cabo," or "cape," which described navigation from cape to cape along the coast without entering the high seas.<sup>340</sup>

In aviation law, cabotage is essentially defined as the transportation of passengers, cargo or mail by a foreign airline between two points in the same nation -- the foreign carriage of domestic traffic. It was first articulated in aviation law in 1910, as the French objected to German balloons flying entering French air space.<sup>341</sup> The Paris Convention of 1919 recognized cabotage formally, providing in Article 16 that nations could favor its airlines "in connection with the carriage of persons and goods for hire between two points in its territory."

Article 7 of the Chicago Convention of 1944 addressed the issue in two sentences.<sup>342</sup> The first provides: "Each contracting State shall have the right to refuse permission to the aircraft of other contracting States to take on in its territory passengers, mail and cargo carried

<sup>337</sup> Value of Airline Stocks Soar Despite Financial Losses, *AVIATION DAILY* (Jan. 8, 1992), at 36.

<sup>338</sup> See *AVIATION DAILY* (Dec. 4, 1991), at 396, and *AVIATION DAILY* (May 3, 1991), at 235.

<sup>339</sup> U.S. Carriers' Market Value Declines to Lowest Point of Year, *AVIATION DAILY* (Dec. 4, 1991), at 392.

<sup>340</sup> Schraft & Rosen, Cabotage Or Sabotage?, *AIRLINE PILOT* (Oct. 1987), at 27 [hereinafter Schraft & Rosen].

<sup>341</sup> Subcomm. on Aviation, Sen. Comm. on Commerce, Science and Transportation, Hearings on S.1300, International Air Transportation Competition Act of 1979, 96th Cong., 1st Sess. 244-45 (1979) (statement of ABA Section on International Law).

<sup>342</sup> Convention on International Civil Aviation, Opened for signature, Dec. 7, 1944, 61 Stat. 1180, T.I.A.S. No. 1591, Art. 7.

for remuneration or hire and destined for another point within its territory." Thus, each nation has exclusive sovereignty over its airspace, and may reserve its domestic traffic to its domestic carriers.

The second sentence of Article 7 provides: "Each contracting State undertakes not to enter into any arrangements which specifically grant any such privilege on an exclusive basis to any other State or an airline of any other State, and not to obtain any such exclusive privilege from any other State." The literal language strongly suggests that if a nation gives away cabotage rights to another state's airline(s), it must give them to all nations on a nondiscriminatory basis.

In the United States, cabotage prohibitions originated in the Air Commerce Act of 1926.<sup>343</sup> Cabotage is generally prohibited under section 1108(b) of the Federal Aviation Act. Under section 401 of the Act, only air carriers (defined as U.S. citizens) may ply the domestic trade.<sup>344</sup> Noncitizens may operate as "foreign air carriers" under section 402, but they must acquire a section 402 permit and their transport rights are limited to foreign air transportation.<sup>345</sup>

In 1991, negotiations between Canada and the United States on a new bilateral air transport agreement included discussions of a partial exchange of cabotage rights. In defining negotiating objectives, Congress in 1979 amended the Federal Aviation Act to include a provision requiring "opportunities for carriers of foreign countries to increase their access to United States points if exchanged for benefits of similar magnitude of United States carriers or the traveling public with permanent linkage between rights granted and rights given away,"<sup>346</sup> Canada has a larger land mass than the United States, and therefore potentially offers more

<sup>343</sup> 67 Stat. 489.

<sup>344</sup> See 49 U.S.C. sec. 1301(3), 1371.

<sup>345</sup> 49 U.S.C. sec. 1301(19), 1372. P. DEMPSEY, LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION 78 (1987).

<sup>346</sup> 49 U.S.C. sec 1502(b)(8).

potential destinations than would most other nations. But the United States has 24 city-pairs that generate more than one million passengers annually, while Canada has but one. The domestic passenger and cargo market in the United States is many times larger and richer than any other domestic market (even that of a combined European Community) that an exchange of equal rights of "similar magnitude" would be a practical impossibility. As Duane Woerth, vice president of the Air Line Pilots Association, noted, "It's like exchanging gold for tin. Only a zealot who believed in trade for trade's sake could support such an imbalance as fair or astute."<sup>347</sup> The disproportionate size of the U.S. market vis-a-vis foreign markets (the U.S. domestic market is more than 40% of the world's total) suggests that no foreign market would be of comparable size to justify an exchange of cabotage rights.

Exchanging cabotage rights would require a statutory change, and therefore could not be negotiated without Congressional approval. Moreover, as noted above, Article 7 of the Chicago Convention insists that giving cabotage rights to one nation requires that it be given to all under a kind of most favored nation basis.

However, an exemption from the cabotage restrictions is available under certain emergency conditions. In 1979, Congress promulgated the International Air Transportation Competition Act, which amended the Act to allow the U.S. Department of Transportation to confer a 30-day exemption from the cabotage prohibition if it finds the "public interest" so requires, and ". . . because of an emergency created by unusual circumstances not arising in the normal course of business, traffic in such markets cannot be accommodated by . . ." U.S.-flag carriers, all efforts have been made to accommodate such traffic needs using U.S. airlines (including their lease of foreign aircraft), and the exemption is necessary to avoid undue

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<sup>347</sup> Letter from Captain Duane E. Woerth to Paul Stephen Dempsey (July 24, 1991).

hardship for the traffic in the market. Where the traffic inconvenience results from a labor dispute, such exemption must not result in an undue advantage to any party thereto.<sup>348</sup>

The Department of Transportation has found that these requirements were satisfied in several emergency situations. For example, DOT granted an emergency cabotage exemption to allow Heavylift (a U.K.-flag carrier) to provide one-way cargo charter flights between Houston, Texas, and St. Thomas, U.S. Virgin Islands, to support recovery operations in the Virgin Islands in the aftermath of Hurricane Hugo.<sup>349</sup> In order to support oil spill clean-up operations at Valdez, Alaska, the DOT granted North West Territorial Airways Ltd. (a Canadian-flag carrier) an emergency cabotage exemption to provide one-way cargo charter operations between Los Angeles and Anchorage.<sup>350</sup>

The DOT has granted such exemptions by telephone. For Example, on April 28, 1987, Qantas Airways (an Australian-flag carrier) requested an emergency cabotage exemption by telephone to transport a single passenger from Honolulu to San Francisco. The passenger was the father of an injured boy being transported from Hadi, Fiji, to the United States on a scheduled Qantas Australia-Nadi-Honolulu-San Francisco flight. DOT concluded that the waiver was clearly required on humanitarian grounds, constituted unusual circumstances, and could not have been accommodated by U.S. carriers since the son was already aboard a Qantas flight and his physical transfer to a U.S. carrier was not practical.<sup>351</sup>

But, when U.S. airlines have been available to provide the service, the DOT has declined to grant the exemption. For example, the DOT denied the application of Lineas Aereas Del Caribe (a Columbian-flag carrier) to transport cattle from Miami to San Juan,

<sup>348</sup> 49 U.S.C. sec. 1386(b)(7). DOT may renew the exemption for periods of up to 30 days. However, the exemption terminates not more than five days after the unusual circumstances that created its need end. *Id.*

<sup>349</sup> Application of Heavylift Cargo Airlines Ltd., DOT Order 89-10-7 (1989), at 2.

<sup>350</sup> Application of North West Territorial Airways Ltd., DOT Order 89-4-1 (1989), at 2.

<sup>351</sup> Application of Qantas Airways Ltd., DOT Order 87-6-63 (1987), at 2.

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Puerto Rico, when it was advised that two U.S. carriers were available to provide the proposed service.<sup>352</sup>

#### B. Code Sharing and Blocked Space Arrangements

Cabotage restrictions may be avoided in various ways, including "sharing codes, making 'blocked space' arrangements for both passengers and cargo, obtaining an ownership interest in a U.S. carrier, making arrangements between U.S. and foreign carriers covering computer reservations systems, and setting up joint frequent flier and marketing programs."<sup>353</sup>

"Blocked space" arrangements involve the leasing or reservation of a specific number of seats by one passenger airline for its passengers to be flown in aircraft operated by another airline. They allow airlines the advantage of offering on-line connections and the potential to draw greater traffic as a result of having one carrier listed in the computer reservations systems, on timetables, and in advertisements, rather than two connecting carriers. For example, Northwest might enter into a blocked space agreement with KLM whereby Northwest would sell up to a specified number of seats on the KLM Minneapolis-Amsterdam flight to Northwest's customers.

"Code share" arrangements involve the listing in the computer reservation systems of the connecting flights of two airlines as a single through flight number. For example, Continental might show a through Continental flight number from Houston to Stockholm via Newark, although the passengers would fly via Continental from Houston to Newark, and via SAS from Newark to Stockholm.

In considering whether blocked space or code sharing arrangements are in the public interest, the DOT considers such issues as the extent to which the authority involved is

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<sup>352</sup> Application of Lineas Aereas Del Caribe, S.A., DOT Order 86-8-37 (1986), at 1.  
<sup>353</sup> Schraft & Rosen, *supra* at 29.

consistent with applicable bilateral air transport agreements, whether reciprocity exists on the part of the nation whose flag the foreign carrier flies, and what benefits would accrue to U.S. carriers, passengers and shippers under the proposed arrangements.<sup>354</sup>

The DOT categorizes "blocked space" agreements, "part-charter" agreements, "code share" agreements, and "wet-lease" agreements as constituting joint service operations, which must be reported to DOT.<sup>355</sup> DOT regulations also require disclosure of code-sharing relationships to consumers. They specify that single air carrier designator codes by two or more air carriers are unfair and deceptive competitive practices within the meaning of section 411 of the Federal Aviation Act unless air carriers, in conjunction with the use of the shared codes, give reasonable and timely notice of the existence of such arrangements. Reasonable notice requires that air carriers, at minimum: (1) identify, with an asterisk or in some other manner, all flights in which the airline code differs from the code of the air carrier actually providing the service; (2) orally inform the consumer that the flight will not be provided by the air carrier whose code is used on the computer, but will instead be provided by a different carrier; and (3) provide frequent, periodic notice in advertising so that potential passengers and travel agents will be cognizant of the code-sharing relationship and the identities of the airlines which are actually providing the underlying service.<sup>356</sup>

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<sup>354</sup> Joint Application of American Airlines, Inc. and Lufthansa German Airlines, DOT Order 91-4-13 (1991), at 2.

<sup>355</sup> 14 CFR sec. 217.10 App. (i)(1). These joint service operations must be reported in Form 41 Schedules T-100 and T-100(f) and fall within the following guidelines: (1) blocked-space, part-charters, and code-sharing agreements must be reported by the air carrier in actual operational control of the flight; (2) wet lease agreements must be reported by the lessee as though the leased aircraft and crew were a part of the lessee's own fleet. 14 CFR sec. 217.10, App. (i)(2). A blocked-space agreement which lasts more than 60 days, or is part of a series of leases that amount to a continuing arrangement lasting more than 60 days, will be construed as a "long-term wet-lease." U.S. carriers file under 14 CFR sec 207; foreign air carrier lessors to U.S. carriers or foreign carriers file under 14 CFR sec. 212. See Application of American Airlines, Inc., DOT Order 87-6-57 (1987), at 1. A "wet-lease" is a lease whereby the lessor provides both the aircraft and the crew.

<sup>356</sup> 14 CFR sec. 399.88

Generally, "blocked-space" arrangements for the shipment of cargo have been allowed.<sup>357</sup> For example, in 1986, the DOT granted Flying Tigers permission to enter into a "blocked-space" arrangement with Canadian Pacific Air Lines [CPAL] pursuant to which CPAL would lease half the cargo capacity on two Tigers' flights from New York to Hong Kong and return, marketing its share of the cargo under Tiger's name.<sup>358</sup>

However, "blocked-space" agreements regarding passenger space have been relatively less successful. For example, in 1987 American Airlines requested permission to enter into a "blocked-space" agreement with Qantas whereby American would provide 10 first class and 25 coach seats on some of its trans-continental flights from Los Angeles and San Francisco to New York, and return. These seats were to be held out as Qantas' with notification to passengers that the service would be provided by American. As a blocked space arrangement of more than 60 days, it was treated by DOT as a "wet-lease" transaction,<sup>359</sup> which would have increased Qantas' capacity between Australia and New York from 0 to 840 seats per month. The DOT concluded that such an arrangement would not then be in the public interest for it would confer a valuable discretionary benefit upon Qantas under circumstances where U.S.-Australian aviation relations were under review.<sup>360</sup> But in 1988, the DOT granted American's previously deferred application for a "blocked-space" arrangement with Qantas, citing changed relations between the United States and Australia.<sup>361</sup>

### C. Foreign Alliances: Frequent Flyer Programs, Computer Reservations Systems and Foreign Ownership

Foreign alliances with U.S. airlines began in the 1980s with shared frequent flyer programs, then entered computer reservations systems, and now have turned to outright equity

<sup>357</sup> American Airlines v. CAB, 358 F.2d 310 (1966).

<sup>358</sup> Joint Application of the Flying Tiger Line, Inc. and Canadian Pacific Air Lines, Ltd., DOT Order 86-12-72 (1986), at 1.

<sup>359</sup> 14 CFR sec. 207.10.

<sup>360</sup> Application of American Airlines, Inc., DOT Order 87-6-57 (1987), at 2.

<sup>361</sup> Application of American Airlines, Inc., DOT Order 88-1-52 (1988), at 1.

ownership. The following chart reveals the alliances of the two dominant European computer reservations systems.

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#### EUROPEAN COMPUTER RESERVATIONS SYSTEMS PARTNERS

<u>Covia</u>	<u>Amadeus</u>
United	Texas Air
British Airways	Air France
KLM	Lufthansa
Swissair	Iberia
Alitalia	SAS
USAir	

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International airline alliances have been stimulated by the prospect for liberalizing European transport in 1992.<sup>362</sup> Having witnessed the intense shakeout deregulation produced in America, foreign management believes that the liberalization of competition rules will result in extreme concentration. The conventional wisdom is that, when the dust settles from U.S. deregulation and international aviation liberalization, only a handful of global megacarriers will dominate air transport. Several industry experts predict that the world's air transport system will eventually be dominated by just eight to ten global megacarriers.

Wanting to be among the survivors motivated the contemporary surge in international combinations and alliances. Moreover, with the Europe's aviation infrastructure even more saturated than America's, opportunities for growth are largely limited to acquiring or affiliating with existing airlines.

Foreign airlines are deeply interested in penetrating the U.S. passenger market -- a market larger than that of the rest of the world combined. In the last few years, KLM bought a huge piece of Northwest, SAS purchased a chunk of Continental, Singapore Airlines and Swissair each acquired a slice of Delta, and British Airways (which gobbled up British

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<sup>362</sup> Dempsey, *Aerial Dogfights Over Europe: The Liberalization of EEC Air Transport*, 53 J. AIR L. & COM. 615 (1988); P. DEMPSEY, *LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION* 93-108, 241-56 (1987).

Caledonian) sought a share of United Airlines. The following chart depicts the substantial foreign airline interests in U.S. flag carriers:

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FOREIGN AIRLINE OWNERSHIP OF U.S. AIRLINES

<u>Foreign Airline</u>	<u>Percentage Ownership</u>	<u>U.S. Airline</u>
SAS	18.4%	Continental
Swissair	5%	Delta
Singapore Airlines	5%	Delta
Ansett Airlines	17%	America West
Japan Air Lines	20%	Hawaiian Airlines
KLM	49%	Northwest
British Air	15%*	United
* proposed; later withdrawn		

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The equity interests by Scandinavian Airline System [SAS] in Continental Airline Holdings was inspired by the American carriers' need for a substantial infusion of new capital. From SAS's perspective, the Texas Air alliance gave it new feed into its transatlantic routes; SAS moved its international hub from New York Kennedy Airport to Newark, where Texas Air's Continental and Eastern could provide domestic feed.<sup>363</sup> (However, SAS may have over-extended itself, and is now retrenching). Swissair's and Singapore Airlines' interest in Delta appears to have been inspired by different reasons -- the desire of Delta to have a friendly partners poised to fend off LBOs.

But most are motivated by foreign airlines' interests in creating operating and market alliances. Thus, they invest "dumb equity", accepting sub-optimal returns because they anticipate synergistic revenue on the passenger feed U.S. airlines promise them, and the diminution of competition thereby created.

Not only are foreign airlines affiliating with U.S. carriers. Other international aviation alliances are emerging, including British Airway's acquisition of British Caledonian, and Air

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363 Repeating Mistakes, Journal of Commerce, Aug. 30, 1989, at 8A.

France's purchase of UTA. The following chart reveals the major ownership interests of foreign airlines:

**CROSS OWNERSHIP AGREEMENTS BETWEEN FOREIGN AIRLINES 364**

Purchaser	Percentage Ownership	Target
Air France	1.5%	Austrian Airlines
Air France	71%	UTA
Air France	37%	Air Inter
Air France	2%	Austrian Airlines
American	8%	Air New Zealand
ANA	10%	Austrian Airlines
Cathay Pacific	35%	Dragonair
Delta	3%	Singapore Airlines
Delta	5%	Swissair
Iberia	85%	Aerolineas Argentinas
Japan Air Lines	8%	Air New Zealand
KLM	15%	Air UK
Qantas	20%	Air New Zealand
SAS	5%	Swissair
SAS	35%	Lan Chile
SAS	25%	Airlines of Britain
SAS	16%	CTA
Singapore	3%	Swissair
Swissair	10%	Austrian Airlines
Swissair	5%	SAS

Here's a college board exam question: if Delta owns 5% of Swissair, and Swissair owns 5% of SAS, and SAS owns 18.4% of Continental, how much of Continental does Delta control?

Almost all bilateral air transport agreements require that carriers designated thereunder be owned and controlled by citizens of the nation from which they originate. Hence, there is no concept of "flags of convenience" in aviation as there is in maritime law.

Foreign ownership restrictions have long been imposed in a number of infrastructure industries in the United States, including telecommunications, broadcasting,<sup>365</sup> electric power

<sup>364</sup> Testimony of Helene Becker (vice president, Lehman Brothers) Before the Subcomm. on Aviation of the House Comm. on Public Works and Transportation (Feb. 6, 1991), at 5. Going Steady, ECONOMIST (July 22, 1989), at 39; and Overlapping Airlines: Recent Investments, Wall St. J., July 23, 1991, at A6.

<sup>365</sup> Foreign owned or controlled corporations are prohibited from receiving licenses to operate as instruments for the transmission of communications. A corporation is defined as foreign-owned if any

production,<sup>366</sup> nuclear power production,<sup>367</sup> inland and intercoastal shipping,<sup>368</sup> mining on federal lands,<sup>369</sup> and aviation. These requirements reflect the importance these infrastructure industries have in supporting national defense.

Essentially, eligibility to register an airline in the United States is limited to: (a) United States citizens; (b) partnerships in which all partners are United States citizens; or (c) U.S. corporations in which at least two-thirds of the board of directors are U.S. citizens and at least 75% of the voting stock is owned by U.S. citizens. Moreover, the right to enter into cabotage (trade or transport between two points within the United States) is limited to domestically registered aircraft.<sup>370</sup>

Section 408(a)(4) of the Federal Aviation Act made it unlawful "for any foreign air carrier or person controlling a foreign air carrier to acquire control in any manner whatsoever of any citizen of the United States substantially engaged in the business of aeronautics."<sup>371</sup>

Historically, a presumption of control existed where ownership exceeded 10% of the airline.<sup>372</sup> Securities and Exchange Commission reporting requirements are triggered by the

director or officer is an alien, or if more than one-fifth of its capital stock is owned by aliens, a foreign government, or a corporation organized under the laws of a foreign country. Additionally, a corporation is generally considered as foreign-controlled if it is directly or indirectly controlled by any other corporation, at least one-fourth of whose capital stock is owned by foreign interests. 47 U.S.C. sec. 310(b).

<sup>366</sup> Hydroelectric power sites on navigable streams located within the United States may be developed only by U.S. citizens or domestically organized corporations. 16 U.S.C. sec. 797(e).

<sup>367</sup> No licenses for the operation of atomic energy utilization or production facilities may be issued to aliens or to foreign-owned or foreign-controlled corporations. 42 U.S.C. sec. 2133.

<sup>368</sup> The Jones Act of 1920 requires that any shipping of passengers or property between points in the United States or its territories must be accomplished in vessels constructed and registered in the United States and owned by U.S. citizens. A ship may not be registered in the United States unless the corporation's principal officers are U.S. citizens and 75% of the stock is owned by U.S. citizens. Any vessel that is at any time registered in a foreign country permanently loses these United States shipping rights. Moreover, any eligible vessel weighing more than 500 gross tons that is later rebuilt outside the United States also forfeits these privileges. However, vessels registered in foreign nations granting reciprocal privileges to U.S.-flag vessels may perform intercoastal transportation of empty items, such as cargo vans, barges, shipping tanks, and equipment utilized therewith. 46 U.S.C. sec. 883.

<sup>369</sup> 30 U.S.C. sec. 22, 24, 71, 181, 352.

<sup>370</sup> 49 U.S.C. sec. 1378, 1401, 1508.

<sup>371</sup> 49 U.S.C. sec. 1378(a)(4). The authority of the Department of Transportation under this provision was terminated as of January 1, 1989. 49 U.S.C. sec. 1551(a)(7).

<sup>372</sup> 49 U.S.C. sec. 1378(f).

acquisition of 5%. In reality, ownership of substantially lesser percentages of widely held corporations can result in effective "control" (although, as we shall see, the current view of the DOT is that foreign control of U.S. airlines almost never exists). Moreover, it is unlikely that a foreign investor would be interested in investing substantial capital in an airline he could not effectively control.<sup>373</sup> But in the event a foreign citizen should be deemed by DOT to have "control" of a U.S. airline, it would no longer be deemed a U.S.-flag carrier, and hence prohibited under the cabotage restrictions (described above) from plying the domestic trade.

Another statutory provision provides that in order to qualify as a U.S. citizen (i.e., a U.S.-flag carrier), the airline must have as its ". . . president and two-thirds or more of the board of directors and other managing officers thereof . . . [U.S. citizens and] at least 75 per centum of the voting interest is owned or controlled by persons who are citizens of the United States . . .".<sup>374</sup>

These are, then, separate requirements -- that no foreign citizen or airline "control" a U.S.-flag carrier, and that no foreign citizens serve as president, hold more than two-thirds of the seats on the board of directors, or more than 25% of the voting stock of a U.S. airline.

DOT has also employed its fitness requirements under section 401(r) of the Act to monitor foreign control issues.<sup>375</sup>

As to control generally, DOT said this:

[F]oreign influence may be concentrated or diffuse. It need not be identified with any particular nationality. It need not be shown to have sinister intent. It need not be continually exercisable on a say-to-day basis. If persons other than U.S. citizens, individually or collectively, can significantly influence the affairs of [the U.S. carrier], it is not a U.S. citizen.<sup>376</sup>

<sup>373</sup> Feldman, *What Are the Chances of Foreign Ownership of U.S. Airlines?*, AIR TRANSPORT WORLD (Nov. 1987).

<sup>374</sup> 49 U.S.C. sec. 1301(16).

<sup>375</sup> 49 U.S.C. sec. 1372(r). Carriers undertaking significant changes in their operations must provide DOT with information relevant to their citizenship and fitness. 14 C.F.R. sec. 204.4.

<sup>376</sup> In the matter of Intera Arctic Services, Inc., DOT Order 87-8-43 (1987), at 5.

The most important case addressing the issue of foreign control of a U.S. airline involved KLM's acquisition of a significant interest in the holding company of Northwest Airlines. In a transaction which increased Northwest's debt-to-equity ratio from 0.42/1 to 5.85/1, in August 1989, Wings Holdings, Inc., acquired control of Northwest with 81.5% debt and 18.5% equity.

Wings' debt was \$3.1 billion, almost two-thirds of which was put up by Japanese banks. Equity was \$705 million, of which Alfred Checchi, Gary Wilson and Frederic Malek put up only \$40 million (for which they received about half the voting and nonvoting common stock), KLM (a Netherlands airline) put up \$400 million (or 57% of the equity, for which KLM received 70% of Wings' nonvoting preferred stock, 31% of its nonvoting common stock, and 4.9% of its voting common stock, as well as a warrant allowing it to convert up to \$50 million of its preferred stock into common stock, some of which could be voting), and Elders IXL (an Australian company) put up \$80 million (or 11% of the equity, for which it received 10% of Wings' nonvoting preferred stock, 16% of its nonvoting common stock, and 15.4% of its voting stock).<sup>377</sup>

Both KLM and Elders had the right to name one representative to the 12-member Wings' Board of Directors. KLM had the right to name a 3-person committee to advise Wings on financial matters, and to enter into a variety of cooperative arrangements with Northwest and preclude such arrangements with other airlines.<sup>378</sup>

In 1989, Secretary of Transportation Samuel Skinner expressed concern over the Checchi group acquisition of Northwest Airlines, not only because the LBO would increase Northwest's debt fourfold, but also because the \$400 million equity participation by KLM

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<sup>377</sup> In the matter of the Acquisition of Northwest Airlines by Wings Holdings, Inc., DOT Order 91-<sup>378</sup> 41 (1991), at 2. <sup>378</sup> Id.

Royal Dutch Airlines would give it about 57% of total equity.<sup>379</sup> Secretary Skinner appeared to interpret section 101(16) of the Federal Aviation Act to limit foreign equity to 25%. As Skinner said,

While KLM's voting share technically fell within the statute's numerical limits [which requires that the airline's President and two-thirds of its Board and other managing officers be U.S. citizens, and that not less than 75% of voting interest be owned and controlled by U.S. citizens], we concluded that KLM's ownership of 57 percent of NWA Inc.'s total equity, together with the existence of other links between the carriers and KLM's position as a competitor, could create the potential for the exercise of influence and control over the carrier's decisions. This would be inconsistent with the law.<sup>380</sup>

In its first order, issued September 29, 1989, the DOT concluded that unless KLM reduced its equity interest to 25%, KLM could be in a position to exert actual control over Wings.<sup>381</sup> DOT expressed concern about the size of KLM's equity interest, both in absolute and proportional terms, its ability to exert influence on Wings, and the fact that it was an actual competitor with Northwest in a number of markets.

DOT acknowledged that determining whether foreign "control" exists is a complex matter:

<sup>379</sup> Statement of Samuel Skinner Before the Aviation Subcomm. of the House Comm. on Public Works and Transportation (Oct. 4, 1989), at 4. Had the management/pilot deal for United not fallen through, British Airways was prepared to supply \$570 million, or 78% of the total \$965 million equity. Valente & McGinley, UAL Machinists Refuse to Back Buy-Out Plan, Wall St. J., Oct. 5, 1989, at A6.

<sup>380</sup> Statement of Skinner, *supra* at 4-5. In September 1989, Skinner jawboned Checchi and Northwest into agreeing, *inter alia*, to limit KLM's voting stock to 25%, and to limit KLM's representation on Northwest's Board of Directors to "matters relevant to KLM's pecuniary interest, recusing himself or herself when the board is dealing with certain matters, such as bilateral negotiations and competitive issues." *Id.* at 6.

<sup>381</sup> In the matter of the Acquisition of Northwest Airlines by Wings Holdings, Inc., DOT Order 89-9-51, at 3.

Analysis in this area has always necessarily been on a case-by-case basis, as there are myriad potential avenues of control. The control standard is a *de facto* one -- we seek to discover whether a foreign interest may be in a position to exercise actual control over the airline, *i.e.*, whether it will have a substantial ability to influence the carrier's activities.<sup>382</sup>

DOT observed that "it is clear from our precedent that a large share in a carrier's equity poses citizenship problems, even where the interest does not take the form of voting stock, particularly if there are other ties to the foreign entity."<sup>383</sup> DOT noted that the incentive for the foreign airline to exert control was much enhanced where it is also an actual or potential competitor. The interest of Elders in Wings appeared to be no more than a pecuniary interest, not rising to the level of concern about control.<sup>384</sup> However, KLM's large equity interest, its right to sit on Wings' Board and name a financial committee, and the working arrangements between the two airlines caused the DOT to conclude that KLM could be in a position to exert control over Northwest, thereby jeopardizing its status as a U.S. citizen. DOT and Northwest entered into a consent order whereby KLM's equity interest in Wings would be reduced to 25%, its power to establish a financial advisory committee would be revoked, and Northwest would fulfill certain reporting requirements.<sup>385</sup>

The disintegration of the economic position of a number of U.S. airlines in late 1990, precipitated by the War with Iraq, escalating fuel prices, fear of terrorism by the traveling public, and a global recession which diminished passenger demand, led the DOT to reverse its position on foreign ownership. The DOT was now willing to take another look at Wings and Northwest. It concluded that Messrs. Checchi, Wilson and Malek were firmly in control of Wings, holding two-thirds of its voting stock and having the power to appoint most of its directors.<sup>386</sup> The DOT announced that it was adopting a new policy:

382 Id. at 4-5.

383 Id. at 6.

384 Id. at 5.

385 Id. at 8.

386 DOT Order 91-1-41 (1991), at 8.

[W]e have reexamined our application of the control test in order to reflect more accurately today's complex, global corporate and financial environment, consistent with the requirement for U.S. citizen control. Specifically, we have reviewed the relationship between voting equity, on the one hand, and nonvoting equity and debt, on the other.<sup>387</sup>

The DOT concluded that foreign equity ownership of up to 49% would be allowed, although foreign voting equity would be limited, as the statute required, to 25%. Foreign debt would not be treated as a control issue.<sup>388</sup> The DOT also indicated that it would not ordinarily allow a foreigner to serve as Chairman of the Board.<sup>389</sup> It had earlier approved the placement of three representatives of SAS on the Continental Airline Holdings' board.<sup>390</sup> KLM could have three seats on the 15 member Wings' board.<sup>391</sup> DOT warned, "the naming of a disproportionate number of foreign director representatives to important committees, such as the executive committee, nominating committee, or finance committee, may be taken as an indication of control and would be cause for us to review the citizenship of the affected air carrier."<sup>392</sup>

The statute has not been amended since Secretary Skinner found that KLM's gargantuan ownership was inconsistent with the law. The U.S. Department of Transportation continues to hold jurisdiction under section 401 of the Federal Aviation Act to scrutinize the fitness of airlines (which includes safety and compliance fitness), and under section 101(16) to review foreign ownership. Under present law, foreign ownership is limited to 25% of the voting stock of U.S. airlines, and no foreign airline can ply the domestic trade.

DOT announced that it will allow foreign equity ownership of up to 50%. Secretary Skinner has also proposed that statutory limits on voting ownership be increased to 49%.<sup>393</sup>

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387 Id. at 9.

388 Id.

389 Id. at 11.

390 DOT Order 90-9-15 (1990), at 6-7.

391 DOT Order 91-1-41 (1991), at 11.

392 Id.

393 McGinley, Transport Aide Backs Raising Limit On Foreign Holdings in U.S. Airlines, Wall St. J., Feb. 20, 1991, at A8.

DOT has even proposed to put the exchange of cabotage rights (the opportunity for foreign airlines to serve domestic routes) on the table in negotiations with the government of Canada, despite the legislative prohibition.

The truth is, with ownership, code sharing and marketing alliances, a foreign airline can effectively control a U.S. carrier, reducing competition in the international market while creating domestic U.S. feed for its international operations. Foreign ownership is the back door to cabotage. With ownership, foreign airlines do not need cabotage rights.

#### *V. CONCLUSION*

The U.S. airline industry is bleeding from a thousand cuts. It has now lost more than twice the accumulated profit earned since it began commercial service in the 1920s.<sup>394</sup> Name another major industry in the history of our republic that has lost all the money it ever made.

Just when we thought the news could get no worse, Wall Street downgraded virtually all of the industry's crushing debt to "junk bond" status.<sup>395</sup> As Wall Street analyst Julius Malodus aptly noted, if the airlines were S&Ls, the government would put them into receivership and liquidate them. In a desperate attempt to stay aloft, airlines are shelving new aircraft orders, trimming and abandoning hubs, and terminating thousands of employees.

About 18% of the industry is already in Chapter 11 bankruptcy, and more stands on the precipice. The ripple effect on Boeing and McDonnell-Douglas, producers of our nation's single most important manufacturing export, has been devastating. Boeing alone is slashing 26,000 jobs from its work force.

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<sup>394</sup> "The nine U.S. major airline companies had a combined net loss of \$5.14 billion last year, which is more than double the \$1.89 billion the same companies lost in 1991." U.S. Major Carriers Lost \$5.1 Billion in 1992, AVIATION DAILY (Mar. 30, 1993), at 495.

<sup>395</sup> See Big Three Placed On CreditWatch By Standard & Poor's, AVIATION DAILY (Jan. 15, 1993), at 77.

Paradoxically, airlines are now more highly concentrated, and less profitable, than ever. Clearly, this is a dysfunctional market, reflecting dysfunctional economic policies.

The airline industry has always flown through the turbulence caused by the updrafts and downdrafts of the market cycle. Before promulgation of the Airline Deregulation Act of 1978, at a time when it was taking delivery of tremendous wide-body capacity, the industry suffered recession, damped consumer demand, and soaring fuel costs. But under regulation, never was a Pan Am or Eastern liquidated, nor a TWA or Continental cast into bankruptcy.

Not to be confused by the facts, laissez faire theologians tenaciously point to consumer savings and declare victory. Never mind the tremendous losses of investors, creditors and workers, or the opportunity costs squandered by imprisoning business travelers in cannisters of aluminum and steel and flying them circuitously through constipated hubs, or that we now Americans fly the oldest fleet of aircraft of any G-7 nation, or that bankruptcies and concentration are growing. Many market economists suffer from a severe methodological handicap by insisting that competition is perfect and a unidimensional assessment of consumer prices is the only salient measure of sound public policy.<sup>396</sup>

True, some consumers do save, paying rates which fail to cover the fully allocated costs of providing service. Of course, below-cost pricing contributes to the industry's insolvency. We are cutting the orchard's trees to harvest the fruit.

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<sup>396</sup> Even the purported consumer benefits of airline deregulation, such as the \$6 billion that the Brookings Institution claims has been saved as a consequence of deregulation, have been contested. See P. DEMPSEY & A. GOETZ, AIRLINE DEREGULATION & LAISSEZ FAIRE MYTHOLOGY 281-95 (1992). Most studies fail to account for the long-term pre-existing trend of declining prices that preceded deregulation. *Id.* at 243-63. The Brookings authors themselves have lowered their estimates by about \$3 billion, a significant confession of methodological error. See *Intelligence, AVIATION DAILY* (Mar. 15, 1993), at 405. A recent study by Morton Beyer reveals that consumer savings would have been ten billion of dollars greater annually had deregulation not occurred. *Deregulation Is Ruining Airlines, Swelling Fares, Study Says, AVIATION DAILY* (Apr. 6, 1993), at 27.

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Moreover, pricing today is monstrously discriminatory. Many consumers pay fares which have soared well above the inflation rate. In fact, small businesses, which create 90% of our nation's jobs, pay obscenely higher prices (vis-a-vis the Fortune 500), causing many reluctantly to boycott air transportation. No nation which values job creation would willfully endorse such a regressive pricing structure.

But under deregulation, we Americans no longer have any say over how our airports and airways -- public resources developed with taxpayer dollars -- serve us. Deregulation traded public interest regulation of the airline industry for airline regulation of the public. To get a decent fare, we must surrender our freedom of how far in advance we plan our trips, how long we stay, and where we sleep on Saturday nights.

Moreover, if consumers are so happy, why is Ralph Nader now describing the airline system as a "public utility"?<sup>397</sup> Why does Consumer Reports describe airline deregulation as "anti-consumer"?<sup>398</sup> Why do polls of frequent flyers reveal a solid majority would prefer re-regulation? Because they have enough common sense to see what only the blind cannot -- that airline deregulation is a failure.

The November elections reveal that the American people reject the failed economic policies of the past 15 years which have made our nation weaker (not stronger), and poorer (not richer), which have saddled our children with enormous debt, and which have contributed

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<sup>397</sup> Martin Tolchin, Clinton To Focus On Helping U.S. Airlines, N.Y. Times, Dec. 27, 1992, at 11.

<sup>398</sup> Dear President Clinton, CONSUMER REPORTS (Jan. 1993), at 6.

to a public and private disinvestment in infrastructure.<sup>399</sup> Deregulation is but one piece of that comprehensive policy of Market Uber Alles.

Market failure has always been an appropriate catalyst for governmental intervention, particularly in infrastructure industries as vital to commerce, communications and national defense as transportation. We need not return airlines to the tight fisted regime of New Deal public utility regulation, nor if Congress acts promptly to save the industry from the concentration levels which will mandate such a draconian result. And there are clearly better solutions than selling off our airline industry to foreign nationals and their governments.

Unfortunately, the public policy debate has degenerated into the polarized extremes of public utility regulation or laissez faire deregulation. The appropriate solution probably lies between, or beyond, them. First and foremost, it involves addressing the unprecedented financial crisis consuming the industry, and its causes.

But we will never find a proper cure for the disease unless we diagnose it correctly, cast aside blind faith in the curative powers of the market alchemists, and move promptly to restore the public interest in safe, dependable, and reasonably priced transportation service. Only then can we regain what was, before deregulation, universally applauded as the "world's finest system of transportation."<sup>400</sup>

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<sup>399</sup> Many have lamented the excesses of the "Eat the Seed Corn" society of the 1980s, and the governmental policies which unleashed them, including the shift of taxes from the rich toward the middle class, the deprivation of revenue for the states, resulting in a deterioration in social services and an increase of the most regressive taxes on the lower and middle classes, the tremendous unprecedented federal borrowing, and the deterioration in the nation's infrastructure, public and private. Deregulation is only one part of that comprehensive, nearly libertarian, effort of the Reagan/Bush era, which has mortgaged the future of our nation. See KEVIN PHILLIPS, BOILING POINT (1993); DONALD BARTLETT & JAMES STEELE, AMERICA: WHAT WENT WRONG (1992); PAUL DEMPSEY, THE SOCIAL AND ECONOMIC CONSEQUENCES OF DEREGULATION (1989).

<sup>400</sup> See Dempsey, The Bitter Fruits of Airline Deregulation, Wall St. J., Apr. 8, 1993, at A 15.

Tragically, Alfred Kahn was true to his promise. The eggs have been so scrambled that they can never be put together again. We cannot neither resurrect the proud airlines that have been lost, nor rectify the emotional and economic injury suffered by hundreds of thousands of loyal employees who have lost their jobs, and investors and creditors who have been stiffed. But unless Congress acts quickly and meaningfully, it will forego its last opportunity to preserve the number of competitors which now exists.

This is not to suggest that the CAB should be resurrected in its 1938 clothes to fix what went wrong. That approach may have been appropriate then, but not now. Regulatory reform was a prudent dose of course correction that the CAB clearly needed.<sup>401</sup> By liberalizing entry and rates, the airline industry was freed to rationalize operations, tap the elasticities of demand to fill seats which otherwise would have flown empty, and thereby enjoy enhanced profits while consumers enjoyed lower fares. It was a win-win situation for the industry and consumers. Unfortunately, the successes of regulatory reform in the late 1970s became the political catalyst for deregulation, persuading Congress to throw the baby out with the bath water.

In recent years, Congress has considered several bills to deal with problems as diverse computer reservations systems, slot constrained airports, and such. The patient is flat on his back hemorrhaging unmercifully, and Congress is offering a couple of aspirin and a glass of water. The disease is deregulation, and the patient desperately needs to be moved to the operating room.

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<sup>401</sup> Alfred Kahn sometimes makes the argument that deregulation began in the mid-1970s, well before he was appointed Chairman of the Civil Aeronautics Board. The modest rate and entry liberalization implemented in that period were actually a process of regulatory reform, clearly warranted by the state of the industry and the times, and permitted under the Federal Aviation Act, a regulatory statute. In fact, full deregulation probably did not actually occur until much later, and one might argue not until the Civil Aeronautics Board was sunset, in 1985. In any event, with the notable exception of Braniff, most carriers engaged in quite conservative behavior in the late 1970s, and were slow to embrace even the relatively modest entry and pricing opportunities given them.

If Congress does nothing, we will likely see an airline industry more highly concentrated than it now is. Because airline managers are rational wealth maximizers, prices will eventually rise and grow even more discriminatory.

If we are to have prudent public policy in transportation, it must begin with an understanding of two major, and two minor, premises:

**FIRST MAJOR PREMISE.** Transportation is an industry in which the public interest is paramount. Like the public utilities, transportation is a necessity. Transportation comprises the very veins and arteries of the nation. It is an integral part of the national infrastructure, essential for commerce, communications and national defense. For that reason, the public has a strong and compelling interest in how it performs its mission on behalf of the public. The public interest is defined by the interest of all constituencies -- consumers, investors, creditors, workers, and taxpayers.

**SECOND MAJOR PREMISE.** Transportation is an industry which has a chronic tendency to engage in below-cost and highly discriminatory pricing, at least until monopoly or a tight oligopoly is achieved. Where carriers compete head-to-head, they tend to price at levels adequate to cover short-term marginal costs, leaving their fixed costs to be recovered, if at all, in those markets in which they enjoy market power.<sup>402</sup> This is true because transportation firms sell what is, in essence, an instantly perishable commodity, the short-term variable costs of operation are both low and somewhat obfuscated,<sup>403</sup> and every firm prices at

<sup>402</sup> The problem is not just industry debt, of course, it is also the endless hemorrhaging caused by pricing the product below cost. Lowering costs can only be achieved in a limited number of ways - cutting labor expenditures, abandoning hubs, and removing taxes and costly regulations, for example. Labor costs have declined as a percentage of operating expenses since 1978. Further reductions would take a restructuring of the Railway Labor Act, which is probably politically infeasible. Moreover, the real problem appears to be the industry's chronic inability to price its product above costs. So further wage reductions might well only be a temporary respite from unprofitability.

<sup>403</sup> Most operating costs are joint costs, spread over origin, intermediate, destination, and connecting points, causing calculations of allocation to be quite difficult to achieve. Moreover, the enormous cash flow of the industry leads to a hand-to-mouth behavior, postponing the day of recovering fully allocated costs.

the margin in order to fill capacity that otherwise would be lost, and thereby preserve market share. Individually rational behavior becomes collective irrational behavior. In the short term, consumers enjoy a windfall, at the expense of investors, creditors and workers, while equipment ages, bankruptcies soar, and all the while, the industry becomes more highly concentrated. As Robert Kuttner observed that airlines are "a highly capital-intensive industry with a standard product [which] cannot stand pure price-competition -- for all the profits would soon be competed away."<sup>404</sup> Left to its own devices, the industry tends toward concentration in the long term.

This was true of the railroads in the 19th Century, before regulation, and true of the airlines and motor carriers in the 1920s and 1930s, again, before regulation.<sup>405</sup> In those days, this industry wide propensity to charge rates below fully allocated costs was referred to as "destructive competition." Today, it might be termed the "death spiral."

It is also important to recognize that the financial problems of the industry were worsened, but not created by, the contemporary recession, as well as the spike in fuel costs and decline in passenger traffic precipitated by the Persian Gulf war. Actually, the blame of fuel increases has been much overstated. Aviation fuel cost the industry less during the Persian Gulf crisis than it did in the early 1980s.<sup>406</sup>

<sup>404</sup> Robert Kuttner, *Flying In the Face of Reason: Why the Skies Need Regulating*, *BUS. WEEK* (May 3, 1993), at 18. He continued, "Airlines dwell not in an Adam Smith world but in a world more reminiscent of economist Joseph Schumpeter's model in which 'efficiency' depends more on technical advances than on price wars." *Id.*

<sup>405</sup> See P. DEMPSEY, *THE SOCIAL AND ECONOMIC CONSEQUENCES OF DEREGULATION* 5-25 (1989); P. DEMPSEY & A. GOETZ, *AIRLINE DEREGULATION & LAISSEZ FAIRE MYTHOLOGY* 159-66 (1992); P. DEMPSEY, R. HARDAWAY & W. THOMS, *1 AVIATION LAW & REGULATION* sec. 1.02-1.08 (1993). It is true of airlines and motor carriers since deregulation.

Airlines were deregulated with the promulgation of the Airline Deregulation Act of 1978. Motor carriers were deregulated with the Motor Carrier Act of 1980. Busses were deregulated with the Bus Regulatory Reform Act of 1982. Railroads, deregulated with the Staggers Rail Act of 1980, are now so highly concentrated and have largely been freed discriminate against captive customers that they have somewhat escaped this downward spiral. Air cargo carriers, deregulated with the Air Cargo Deregulation Act of 1977, are also highly concentrated, and relatively profitable.

<sup>406</sup> Flint, *Don't Blame It All On Fuel*, *AIR TRANSPORT WORLD* (Feb. 1991), at A8.

The financial problems confronting the airline industry preceded deregulation, and were exacerbated by it. During the 1980s, the industry's profit margin fell to six tenths of one percent, compared to an average of between three and six percent for all manufacturers.<sup>407</sup> During deregulation's first decade, the airline industry suffered a 74% decline in its profit margin.<sup>408</sup> During deregulation's first six years, industry costs increased 94%.<sup>409</sup> It would be inaccurate to label the current market downward cycle as the cause of inadequate industry profitability, and only a temporary phenomenon when profitability was highly inadequate before the contemporary events worsened it.

**FIRST MINOR PREMISE.** The airline industry suffers from serious cost and capacity problems. Hub-and-spoking, the dominant megatrend on the deregulation landscape, has created largely duplicative ubiquitous, high-cost transport networks.<sup>410</sup> Moreover, passengers prefer frequency, and frequency adds capacity. The excessive capacity created thereby exacerbated the principle described above, of carriers to engage in below-cost pricing to preserve market share and fill capacity. Moreover, escalating costs have pushed the envelope of prices to the outer limit of demand elasticity.

**SECOND MINOR PREMISE.** The domestic air passenger market may be approaching maturity. Domestic passenger demand appears to be leveling, and many analysts anticipate that such demand will grow at a much slower rate in the 1990s than it did in the 1980s, and at a significantly slower rate than the international market. In part this is attributable to age and

<sup>407</sup> Testimony of Phillip Baggaley Before the Aviation Subcomm. of the House Comm. on Public Works and Transpiration (Feb. 6, 1991), at 3.

<sup>408</sup> U.S. Airline Deregulation a Financial Disaster, AFN Study Shows, Commuter Regional Airline News (Apr. 8, 1991), at 8.

<sup>409</sup> U.S. GENERAL ACCOUNTING OFFICE, COMPETITION: HIGHER FARES AND REDUCED COMPETITION AT CONCENTRATED AIRPORTS 24 (1990).

<sup>410</sup> Hubs are high cost methods of distributing passengers in terms of aircraft and labor utilization and fuel consumption. Cargo doesn't seem to object to the inconvenience, but passengers detest it. Perhaps carriers seeking to serve nonstop routes not currently being served should be awarded limited-term exclusive nonstop route franchises as a means of stimulating nonstop service, thereby providing some collateral for lending. If price ceilings are imposed, the attractiveness of hubs diminishes, for they will no longer produce monopoly rents.

income shifts in the U.S. population base, a saturation of the leisure market, and the current and future technological strides in the telecommunications industry, an alternative for business communications. In part, this is attributable to consumer attitudes developed during the unrealistic airline price wars as to the appropriate price for the product. In part, this is attributable to escalating costs, pushing price against the envelope of demand elasticity. And one frightening possibility is that the airline industry may be experiencing a phenomenon we witnessed in the private intercity passenger rail industry, and in private intracity urban transport – that passengers just won't pay the full cost of operations.

With these essential premises in mind, let us turn to potential solutions to the crisis in the airline industry. Any comprehensive legislative effort to solve the problems in commercial aviation must have three primary substantive objectives:

1. It must attempt to rectify the financial crisis in the airline industry;
2. It must promote consumer equity; and
3. It must allow new firms equitable entry opportunities.

It must also address the procedural question of what sort of government agency should oversee the managed competition this regime requires.

#### A. THE FINANCIAL CRISIS

Addressing the financial crisis in commercial aviation must be the highest priority of the new Administration's DOT. The contemporary financial losses threaten to ground much of the industry. We need to explore creative means to rebuild our nation's aviation system.

Doing nothing is not a responsible option. If Congress does nothing, the industry's financial condition will worsen, its fleet will continue to age, and more carriers will die a slow and agonizing death.

There are five paths to improved balance sheets and potential profitability in the airline industry: (1) a government bail-out; (2) selling off our airlines to foreign citizens and their governments; (3) reformation of the bankruptcy and antitrust laws; (4) economic reregulation; or (5) regulatory reform.

Recognizing the importance of transportation to commerce, communications and national defense, Congress in earlier periods of American history appropriated direct federal subsidies to bail out failing transportation firms such as Conrail, Chrysler, Lockheed, and Amtrak. But the contemporary realities of a \$3 trillion federal debt probably preclude direct subsidies to ameliorate the contemporary crisis in the transportation industry. Various proposals to provide direct or indirect taxpayer assistance (from outright grants, to rolling back taxes, to federal loan guarantees) so as to improve airline balance sheets are band-aids, likely to provide some short-term relief without addressing the fundamental structural problems in the industry. Any such relief must be coupled with a more comprehensive set of remedies to assure that the taxpayer's investment will not be squandered in yet another round of fare wars.

Foreign control potentially jeopardizes national security. More than half of the U.S. wide-bodied fleet is committed to the CRAF program, and military dependence on civilian lift capacity will like increase in the post-cold war era. More than half of the U.S. wide-bodied fleet is dedicated to CRAF. Two-thirds of the soldiers and a quarter of the supplies flown to the Middle East during Operation Desert Shield/Storm were flown aboard U.S. CRAF aircraft. Certainly, although we fought wars with Britain in two centuries, and British soldiers burned down the White House, these days nations like the United Kingdom do not appear to be a military threat to the United States. But recall that the Shah of Iran proposed to buy Pan Am in 1974, at a time when Iran was our closest ally in the Middle East.<sup>411</sup> And recall that not one of our loyal NATO allies in Continental Europe would give the U.S. permission to use

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<sup>411</sup> Dempsey, The Disintegration of the U.S. Airline Industry, 20 TRANSP. L.J. 9, 40-42 (1991).

their air space when President Reagan decided to bomb Libya. If they wouldn't be comfortable with us using their air space, how would they feel about us using their aircraft?<sup>412</sup>

New capital from any source should be welcome, particularly to shore up failing U.S. airlines. But foreign control should be avoided, for foreign control tends to reduce competition in international markets, endangers national security by diluting the loyalty of the CRAF fleet, jeopardizes the integrity of the bilateral negotiating process, and creates an unlevel playing field because of the foreign regime of government ownership, subsidies and regulation.

The airline industry is more highly concentrated than at any time in its history. Nonetheless, duplicative hub networks assure that most long-haul markets suffer from excess capacity. The elimination of some of the weaker airlines will reduce the number of duplicative networks, and thereby enhance profitability of the surviving airlines. But the concentration imperative which deregulation has unleashed has been stymied by the threat of antitrust prosecution, and the bankruptcy laws, which cause airlines to linger on in Chapter 11 with one foot in the grave. A more highly concentrated industry would likely be more profitable. Nonetheless, monopoly or oligopoly control of an essential infrastructure industry like aviation may lead to the exertion of market power, manifested by more highly discriminatory pricing, and the loss of competitive discipline in pricing and service. Ultimately, such abuses could lead to the imposition of public utility regulation on the few remaining firms.<sup>413</sup>

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<sup>412</sup> At any given point in time, about half of our wide-bodied fleet is flying over an ocean, or sitting on the tarmac in a foreign airport. Perhaps we could call up the Israelis and ask them to perform Entebbe type raids to secure a release of sequestered aircraft. But perhaps not.

<sup>413</sup> Eventually, Congress may be faced with the prospect of introducing public utility regulation to the few surviving firms, or failing that, nationalizing the industry. In the author's view regulated competition is preferable to regulated monopoly; regulated monopoly is preferable to nationalization; nationalization is preferable to unregulated monopoly.

Neither of the extremes of nationalization nor the contemporary environment of Market Darwinism are desirable. Public policy in this essential infrastructure industry might best be enhanced by preserving the level of competition which now exists and imposing light-handed regulation upon it, while there are still a sufficient number of competitors to preserve.

As noted above, reregulation of the type attempted in 1938 would not be appropriate today.<sup>414</sup> Public utility regulation may be necessary if the industry degenerates into a tight oligopoly or monopoly, but the vast improvements made possible by regulatory reform in the mid-1970s demonstrated that a tight fisted governmental presence is probably not desirable.

The final alternative is regulatory reform, or if you like, managed competition. Again, it need not embrace economic regulation of the nature created in the 1930s. It can allow the market to determine most of the decisions regarding price and service, leaving government to police excesses at the margin, and provide some level of industry stability. Let us examine what it might contain:

1. **REGULATORY AND TAX RELIEF.** All regulations should undergo cost/benefit scrutiny, and unnecessary regulatory burdens should be eliminated. Any changes must be implemented in a way least likely to cause injury to existing airlines. Equity demands that all airlines be treated equally. And as to taxes, they should be lowered. But any taxpayer investment, direct or indirect, must be protected by a comprehensive remedial program designed to insure that such contribution is not wasted away in a new round of below-cost pricing.
2. **AIRLINE AGREEMENTS.** Much could be done to alleviate congestion and excessive capacity problems by allowing airlines to sit down and talk about solutions thereto.

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<sup>414</sup> Alfred Kahn appears to take the position that there are only two alternatives -- *laissez faire* or public utility reregulation. See *Airlines Suffer — For a Better Future*, Wall St. J., May 3, 1993, at A17. As a student of industry regulation, he should know there are many different shades of grey in regulation. One need only look at the plethora of alternative models adopted by the states in intrastate telephone regulation following AT&T divestiture, or the fact that broadcasting regulation is limited largely to entry, and not rate regulation, except in the cable television reregulation legislation passed over President Bush's veto last year. Railroad pricing regulation is limited to those areas where railroads enjoy "market dominance," and is elsewhere regulated by the market. Rather than an "on-off" switch suggested by Kahn's view, the hand of government is on a dimmer switch which offers a multitude of alternative levels of government oversight. That, Kahn should have learned as he turned the dial toward liberalized entry and rate regulation while Chairman of the Civil Aeronautics Board in the late 1970s.

Cooperation between airlines can sometimes reduce industry costs while providing better service to the public. The government should, of course, monitor such discussions so as to protect consumers and other airlines from anticompetitive behavior. But antitrust immunity might be conferred for those arrangements which serve the public interest by better rationalizing the air transport system. This could help alleviate wasted capacity, ease airport congestion and delay, reduce fuel consumption, and improve the economic health of airlines. Mandatory retirement of old, noisy, fuel-inefficient aircraft should be required.

3. **FITNESS.** Congress should pass legislation imposing fitness standards prospectively prohibiting any future LBO or other excessive enhancement of carrier debt, force airlines to wean themselves of existing debt over a period of time, and prohibit public assets (such as international routes, landing slots and gates) to be sold off to enhance the personal wealth of corporate raiders. Fitness scrutiny might be exerted against any airline either entering bankruptcy, having an excessive debt-to-equity ratio, or having an excessively aging or inadequately maintained fleet. New accounting standards should be adopted to give a clearer picture of debt, requiring capitalization of leases, frequent flyer obligations, and other liabilities. Debt/equity targets should be announced, to be phased in over time.

4. **BANKRUPTCY.** The bankruptcy laws should be amended to prevent Chapter 11 carriers from pricing below fully allocated costs, assuming no bankruptcy, with an exception allowed for meeting the lower fare of a competitor. A specific time limitation should also be imposed on carriers entering Chapter 11, requiring them to emerge or liquidate within a specified number of months. Nine months might be an appropriate gestation period.

5. **INTERNATIONAL AVIATION.** All bartering of international aviation rights should be done on the basis of an equal exchange of opportunities. Access to the U.S. market, either through marketing alliances, equity ownership, or route authority should be given only to those nations offering equivalent market opportunities. Carriers should be selected to serve

international routes on the basis of which carrier is best able to provide vigorous competition to the foreign carriers in the market, and best able to serve consumers.

6. LOAN GUARANTEES. The capital requirements of the U.S. airline industry are enormous. With today's deficit, a government bailout, a la Conrail and Lockheed, is probably not feasible. Neither probably are tax credits for new equipment purchases. However, we might explore using some slice of the Airport and Airway Trust Fund to provide federal loan guarantees to domestic airlines for new aircraft, provided old aircraft are retired. Some have suggested requiring the elimination of two seats for every one acquired under such a program. The idea has merit. But again, any public contribution to the industry must be encompassed within a comprehensive package of remedies to the more fundamental and long-term industry problems, such as those suggested herein, so as to protect the taxpayer's investment.

If our government dedicates itself firmly and forcefully to shoring up the financial health and financial prospects of the industry, the private capital markets will become available quite quickly, creating stronger airlines better positioned economically and efficiently to serve the public interest.

#### B. CONSUMER EQUITY

1. PRICING SIMPLIFICATION. With between 40,000 and 100,000 price changes a day, information costs have soared. Consumers deserve to have pricing information which allows them to compare alternatives rationally. The European Economic Community has adopted four fare categories, with restrictions tied to each alternative.<sup>415</sup> Such a tiered price structure would lend sanity to the labyrinth. Some have suggested resurrecting the old statutory just and reasonable and nondiscriminatory rate provisions of the Federal Aviation Act. Perhaps some of the regulatory reform pricing provisions of the Airline Deregulation Act or the new

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<sup>415</sup> See Dempsey, European Aviation Regulation: Flying Through the Liberalization Labyrinth, 15 BOS. COLLEGE INT'L & COMP. L. REV. 311 (1992).

European rules might be appropriate. Pricing standardization would much enhance consumer equity and hopefully provide the industry with some opportunity for pricing stability.

2. PRICING DISCRIMINATION. Both airline profitability and consumer equity will be enhanced by eliminating pernicious forms of pricing discrimination, such as corporate discounting. Small businesses create the lion's share of the nation's jobs, and they are seriously disadvantaged by the contemporary transportation pricing structure. The Clinton campaign committed itself to job creation, so this type of discrimination might be challenged on equity and economic grounds. Of course, pricing differentials ought to be allowed for discretionary traffic, so as to allow airlines the flexibility to tap the elasticities of demand to fill seats which otherwise might fly empty.

3. MONOPOLY RENTS. As a general rule, the government should stay out of the business of setting fares where sufficient competition exists to discipline airlines. Take some appropriate measure of competition at airports or in nonstop city-pair markets (say, some appropriate point on the Herfindahl-Hirshman Index, or some other definition of market dominance),<sup>416</sup> and let airlines price as they will. But in markets dominated by only one or two carriers, a price ceiling should be imposed to prevent the extraction of monopoly rents. The ceiling could be based on average industry fares for similar stage lengths, or carrier costs.

4. UNFAIR AND DECEPTIVE COMPETITIVE PRACTICES. Code sharing, bait and switch advertising, misleading scheduling, travel agent commission overrides, demand based flight cancellations and other deceptive practices should be prohibited. Congress should adopt a Code of Fair Competitive Practices defining what is not permitted and providing penalties for violations. Alternatively, Congress could eliminate federal preemption over such questions, letting the state Attorney Generals loose. But that would subject the industry to a more complicated, and confusing, legal labyrinth.

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<sup>416</sup> See Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895, 49 U.S.C. sec. 10701(a)(b)(1).

**5. MERGERS AND ACQUISITIONS.** Anticompetitive mergers and acquisitions can injure consumers. Any merger or acquisition should require pre-consummation governmental review to determine the transaction's impact on competition, service, pricing, and the financial condition of the surviving airline. In order to enhance the financial viability of the industry and reduce redundant capacity, stronger airlines should be encouraged to acquire weaker carriers. In order to preserve competition in international markets and the ability of the U.S. commercial fleet to facilitate national defense needs under the Civil Reserve Air Fleet program, foreign control restrictions should be maintained.

#### C. NEW ENTRY

Ultimately, any comprehensive statutory proposals have to address in some way the entry barriers of access to slots and gates, as well as computer reservations systems bias, but do so delicately, so that the established airlines aren't financially injured in the process.

- 1. AIRPORT ACCESS.** Majority in interest clauses should be examined to determine whether incumbent airlines use them to restrict entry unduly. Airports should be free to exercise eminent domain powers to recapture underutilized gates or landing slots, at fair market failure, and lease them to new entrants, or convert gates to multiple carrier use.
- 2. AIRPORT CAPACITY.** Airports are public resources. Federal preemption of noise and other environmental issues might well enable the needed additional infrastructure development. Peak period pricing could flatten congestion.
- 3. FREQUENT FLYER PROGRAMS.** To give smaller airlines a better chance to compete, frequent flyer awards should be taxed.
- 4. PREDATORY PRACTICES.** Carriers and consumers should be able to file a complaint and have a hearing against rivals which engage in predatory pricing, scheduling, and airport monopolization.

5. NONSTOP ROUTE CERTIFICATES. Hubbing-and-spoking, the dominant megatrend on the deregulation landscape, is choking the air transport system, reducing aircraft and labor utilization, and burning excessive fuel. New nonstop service overflying hubs might be inaugurated if airlines could receive a protected franchise for a term of years. A franchise to serve any city-pair not now receiving nonstop service ought to be available to an airline promising to provide at least one round-trip a day. It would receive an exclusive franchise to serve the market for say, 3-5 years.

#### D. THE PROCEDURAL ISSUE

Article 1, section 8, of the U.S. Constitution vests in Congress the power to regulate interstate and foreign commerce. Since 1985, however, such powers have been vested in the Executive Branch.

As the Reagan and Bush Administrations revealed, excessive White House influence can lead to a highly ideological result. Economic regulatory functions over aviation should be placed in an independent agency, shielded from the political winds that blow down Pennsylvania Avenue. Autonomy, responsibility and fair mindedness are essential to good government.

This agency should be modeled after the Federal Reserve Board, with individuals appointed having high levels of aviation expertise, appointed for long, but nonrenewable terms, removable from office only for malfeasance. So as to prohibit radical policy shifts, and manage the work load, the new commission should be a collegial body, with five or seven members. If need be, all the regulatory functions over all modes of transport (air, rail, motor, bus and domestic and international water carriers) could be vested in a new intermodal U.S. Transportation Commission, folding into it jurisdiction now held by the DOT, the Interstate Commerce Commission, and the Federal Maritime Commission.

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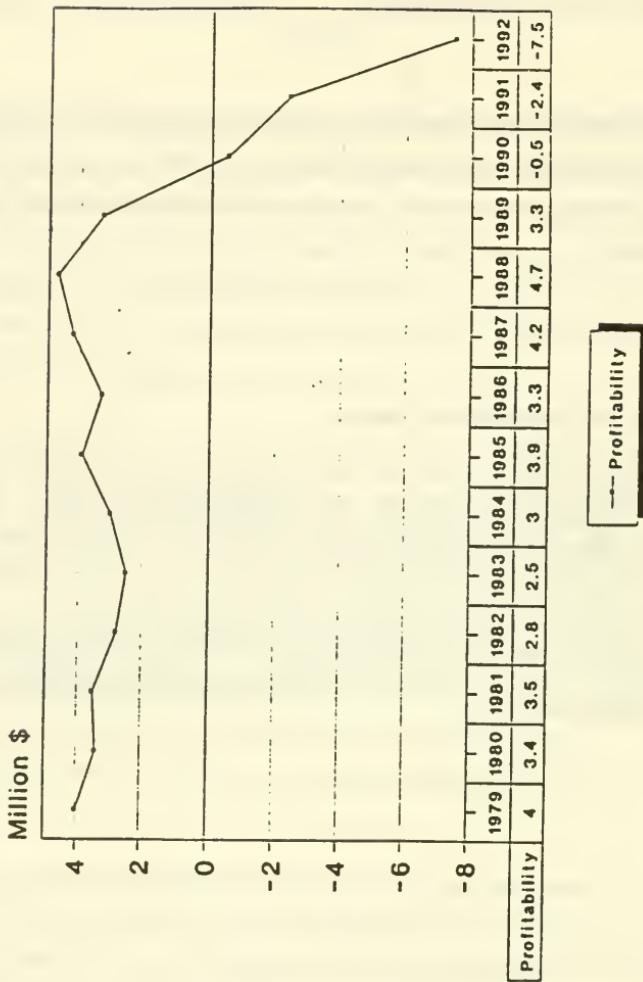
Our nation needs an aviation system in which efficient carriers earn a reasonable return on investment, and provide safe, adequate and dependable service to the public at a fair, reasonable, and nondiscriminatory price. No modern industrial nation deserves less from its infrastructure.

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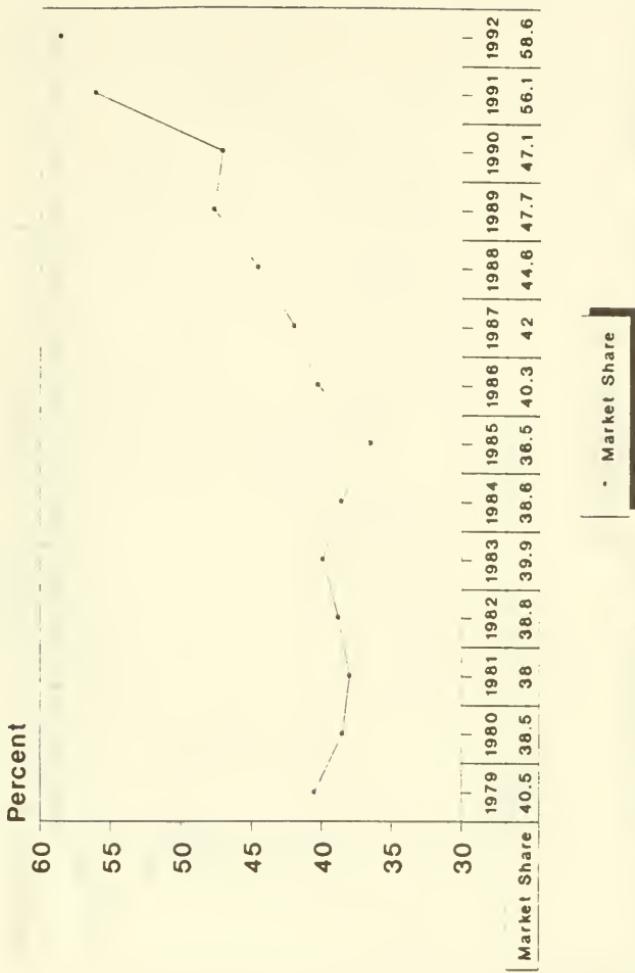
\*\* Paul Stephen Dempsey is Hughes Professor of Law and Director of the Transportation Law Program at the University of Denver. He formerly served as an attorney with the Civil Aeronautics Board and the Interstate Commerce Commission in Washington, D.C.. He is the author of the following books: AVIATION LAW & REGULATION (2 volumes, Butterworths 1993); AIRLINE DEREGULATION & LAISSEZ FAIRE MYTHOLOGY (Quorum Books 1992); FLYING BLIND: THE FAILURE OF AIRLINE DEREGULATION (Economic Policy Institute 1990); THE SOCIAL AND ECONOMIC CONSEQUENCES OF DEREGULATION (Quorum Books 1989); LAW & FOREIGN POLICY IN INTERNATIONAL AVIATION (Transnational Publishers 1987); and LAW & ECONOMIC REGULATION IN TRANSPORTATION (Quorum Books 1986). Dr. Dempsey holds the following degrees: A.B.J., J.D., University of Georgia; LL.M., George Washington University; D.C.L., McGill University. He is admitted to practice law in Colorado, Georgia and the District of Columbia.

ACCUMULATED AIRLINE PROFITABILITY  
(in million \$)



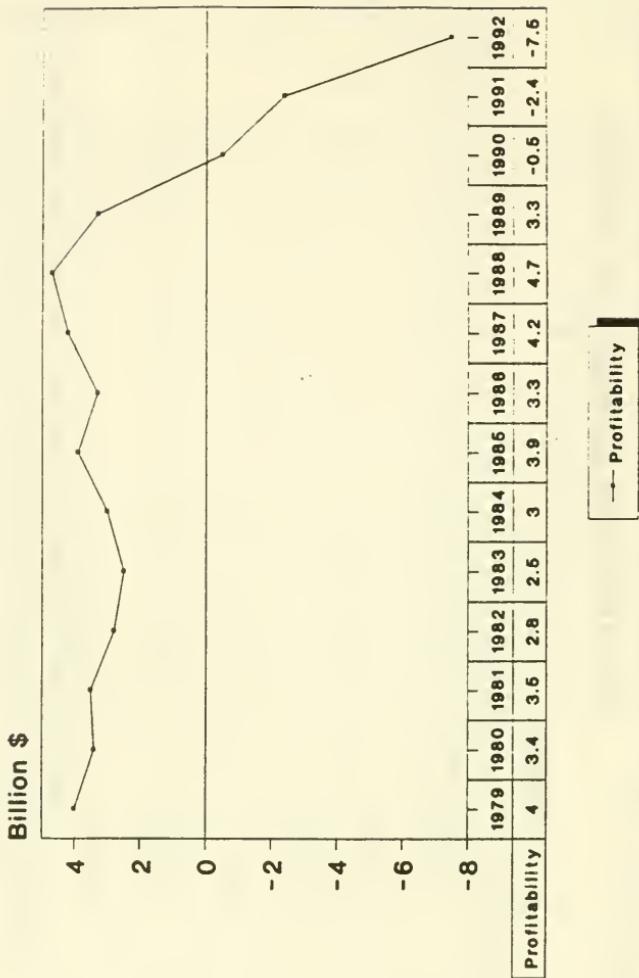
Revised April 2, 1993

## TOP THREE AIRLINES' MARKET SHARE (in revenue passenger miles)

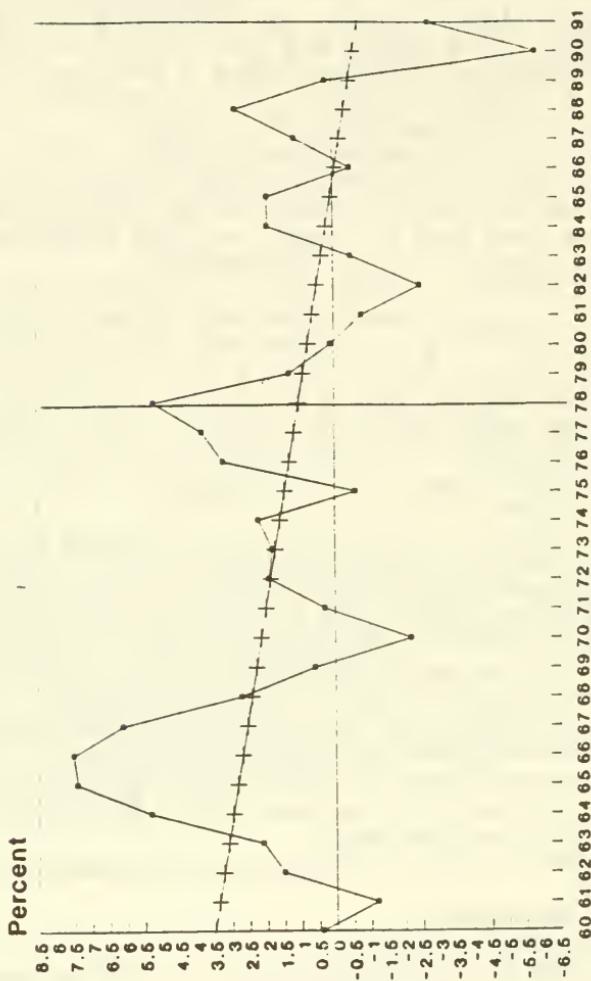


Revised April 2, 1993

ACCUMULATED AIRLINE PROFITABILITY  
(in billion \$)



# Airline Industry Net Profit Margin 1960-1991



Mr. BROOKS. I want to take this opportunity to introduce the distinguished chairman of the transportation agency in the State of Texas, Mr. David Bernsen, an outstanding lawyer in Beaumont, TX. He is a good man. I told him we had to finish this thing because otherwise our transportation in Beaumont would be by helicopter from place to place. Now he too has airlines under the jurisdiction of the Transportation Department.

Professor, while you are there and still warmed up, in your book, "Flying Blind: The Failure of Airline Deregulation," you wrote that significant new entry is highly unlikely in the deregulated airline industry. How does this square with the recent spate of new entries that the industry has experienced?

Mr. DEMPSEY. The key word is "significant." If you take a look at all the new entrants that have emerged since deregulation began in 1978, only two of them ever achieved major carrier status. One was Midway and the other is America West. Midway has been liquidated. America West is in chapter 11 bankruptcy.

Without some significant changes in the way government provides oversight to this industry, I do not believe that we will see significant new entry into this industry.

Mr. BROOKS. Well, thank you very much.

Ms. Golodner, I will submit some questions to you, if I may. I want to tell you I appreciate your being very patient. As I said, the answers were even longer than the questions, and members ask long questions most of the time. Today the answers were longer. They never arrived on time on answers, at least not yet.

Ms. Golodner, under what circumstances would you favor foreign carriers being able to invest in domestic airlines, if any?

Ms. GOLODNER. You answered the question yourself when you mentioned questions that should be addressed to Mr. Kantor. We are concerned about fair trade policy for our U.S. carriers, and right now there is not an even playing field for U.S. carriers. We would like to see that occur.

Mr. BROOKS. And we have a couple of questions I will submit to you also.

[See appendix 2.]

Mr. BROOKS. Mr. Fish.

Mr. FISH. I ask unanimous consent to also ask questions.

Mr. BROOKS. Without objection.

[See appendix 2.]

Mr. FISH. I have one for Professor Dempsey to get his view of British Airways taking a position in USAir. One argument is that it is good for consumers, it strengthens consumers, this foreign infusion of money, and we do know that Continental has emerged from bankruptcy with the help of foreign investment and is now offering a choice to consumers.

What is your view of the USAir, British Airways deal?

Mr. DEMPSEY. The first effort was very troublesome because it included an exorbitant amount of control by the British company of the U.S. company. I believe there are significant national security reasons why such control ought to be scrutinized very carefully.

The second revised effort was not as troublesome. I am a little concerned for national security reasons about the precedent that it

establishes. And I would agree with Mr. Crandall that in fact there is not a level, balanced playing field here between U.S. and foreign airlines. We have to recognize that.

Foreign airlines are either governmentally owned, governmentally subsidized, or even if they are privatized, they come to the industry with clean balance sheets. So if British Airways wants to raise \$600 million, it can do so at the snap of a finger.

We still have foreign governments with very paternalistic attitudes with respect to their carriers. We are dealing with an entirely different regime and we shouldn't naively assume that an unfettered marketplace is at work.

I am not comfortable with any notion that we just walk away and let foreign airlines take over the U.S. industry. But I have no trouble with an infusion of capital.

Mr. FISH. Ought we to limit the infusion of percentage ownership to 25 percent for foreigners?

Mr. DEMPSEY. I am not concerned about the percentage of ownership. As you know, in any diversified corporation in the United States, if you own 2 or 3 percent you can exert effective control. I wouldn't advocate increasing the 25-percent rule. I think the real question is whether there is control.

Mr. FISH. Thank you.

Mr. DEMPSEY. If you like, I will give you an example of why it is troublesome from a national security perspective. In Operation Desert Storm, two-thirds of the soldiers and 25 percent of the supplies were flown aboard our C.R.A.F. fleet, the wide-bodied aircraft of the United, American, Delta, Northwest—

Mr. BROOKS. Will you give me a definitive on that in writing? Expand a little bit on that, if you would.

We have asked some individually, but you may have some overall statistics and figures that would be useful.

Mr. DEMPSEY. Certainly.  
[The information follows:]

RESPONSE TO QUESTION ON FOREIGN OWNERSHIP POSED BY  
CONGRESSMEN BROOKS AND FISH, BY PROF. PAUL S. DEMPSEY

Now that deregulation has failed to produce the near perfect model of textbook competition the laissez faire economists predicted, the deregulationists are proposing to sell our domestic industry off to foreign airlines. Already Northwest, Delta, Continental, USAir, America West and Hawaiian Airlines have significant foreign equity, much of that increased by the DOT in 1991, which authorized foreign ownership of up to 49% of total equity.

Most foreign airlines are owned, in whole or part, by their governments. Monopoly is not the antithesis of competition; socialism is. A government owned or subsidized airline need not make a profit to stay alive, and therefore lacks a proper competitive discipline. Their presence in a "free market" creates an unlevel playing field. Government treasuries have financial resources beyond the dreams of privately owned companies. Foreign governments can subsidize losses or underwrite the capital requirements necessary to develop monopoly positions.

At the outset of deregulation, some predicted that ultimately only a handful of airlines would survive, and that they would be nationalized as wards of the state. Never did they dream that the few surviving airlines would be wards of foreign governments. Paradoxically, we have now

embarked upon a regime of partial nationalization, not by our government, but by foreign governments.

Foreign ownership restrictions have long existed for many of our essential infrastructure industries--airlines, intercoastal and inland shipping, telecommunications, broadcasting, electric power production, and nuclear energy. These restrictions were added to our law not because of blind xenophobia, but because of legitimate national security considerations.

As operation Desert Shield confirms, the nation depends on the aircraft of our domestic airlines committed to the Civil Reserve Aviation Fleet [CRAF] as the essential logistical means to ferry troops and supplies to distant battlefields. We need the CRAF fleet for airlift capacity in time of war. Foreign ownership may jeopardize access to it. The Air Force simply doesn't have enough C-5As to do the job. And the U.S. military lift capacity will likely be reduced in the post-Cold War era, leading to increased reliance on the domestic civilian fleet.

On August 2, 1990, Iraq invaded Kuwait. Two weeks later, the CRAF fleet was activated -- the first time since its creation in 1951. Calling up the CRAF fleet was essential in order to meet the demands of the most massive airlift since the Berlin Airlift in 1948. During the first two months of activation, CRAF planes flew more than 500 missions, carried 66,000 passengers (mostly soldiers) and 22,000 tons of cargo.

In the recent Persian Gulf crisis, we relied upon our domestic civil reserve aviation fleet [CRAF] --the aircraft of carriers like United, America, TWA, Northwest and Continental -- to ferry 60% of the soldiers and 23% of the supplies to the dessert battlefield. Yet some would have foreign governments sit on the boards of directors of U.S. airlines.

We also maintain a federally subsidized U.S.-flag fleet of ocean carriers because of the lesson we learned in World War I -- when we looked around for essential ships to ferry troops and supplies across the Atlantic, there were nearly none. Not that long ago, the federal government bailed out a collapsing Conrail and Lockheed, in part, because of their importance to national security. Transportation is essential to our national defense.

Some argue that we could simply commandeer the aircraft of foreign-controlled U.S. airlines if we needed them -- seize the property of foreign companies as other nations have done to American firms. But at any given time, more than half of the fleet is somewhere over an ocean or sitting parked on a foreign tarmac. What will we do if we found ourselves in a foreign conflict and need the planes, call up the Israelis and ask if they would lend us their commandos to perform "Raids on Entebbe" around the world?

Moreover, acquisition of capacity is not the only problem. Those who argue for foreign ownership of domestic airlines forget that most of the technological breakthroughs

of aviation were inspired by its military applications -- its proficiency in delivering troops and bombs. Imagine a world where we had never prohibited foreign ownership or foreign airline competition. How much worse would World War II have been if the dominant domestic airlines in 1940 had been Lufthansa and Japan Air Lines?

Although we fought wars with Britain in two centuries, and British soldiers burned down the White House, British Airways doesn't look like much of a national security threat these days. But our alliances are constantly shifting, so that an Aeroflot looks more or less threatening depending upon the point in history at which you ask the question. We embraced Stalin to fight Hitler, and Syria's Assad to destroy Saddam Hussein. Today, could we object to a sale of TWA to Iraqi Airways?

In 1974, the Shah of Iran proposed to buy Pan American World Airways. If foreign ownership rules had been relaxed in the 1970s, the sale would have been approved on grounds that the Shah had been a steadfast ally of the United States, and that Iran was the friendliest of Persian Gulf nations.

We all know the tragic events which transpired in Iran after the fall of the Shah. If the foreign ownership rules adopted by DOT in 1991 had been in effect in 1974, would Iranian President Rafsanjani today by Chairman of Pan Am's Board, and during Operation Desert Storm, would Pan Am's

CRAF 747s have been parked on Iranian military airfields next to Iraqi jet fighters?

Another example: in the mid-1980s, President Reagan decided he had enough of the exportation of terrorism by Mr. Khadaffi, and ordered Tripoli bombed. Lay to one side the question of whether the United States should have bombed Libya. The State Department asked our loyal allies whether they would mind if we used our jets parked on our military bases to drop payload on Libya. Only the U.K. said yes. Not only did our loyal NATO allies on the Continent of Europe refuse to allow us to use our jets or landing fields, they would not even consent to our use of their air space. We had to fly Air Force jets from Great Britain, out into the Atlantic, through the Straits of Gibraltar, and up the Mediterranean to drop bombs, and then all the way back again. As a consequence, we lost a couple of pilots. Now, if our loyal allies would feel uncomfortable about using their airspace to engage in a foreign conflict with which they disapproved, how would they feel about the use of their aircraft?

We need to keep our essential infrastructure industries out of foreign hands so that we don't wake up one day in the midst of a global crisis wondering why we were so short sighted as to allow them to be crippled by our adversaries. We don't want foreign owners sabotaging, disrupting or delaying the free movement of commerce, or communications, or electric power. We need a healthy domestic

infrastructure capable of serving the nation loyally in times of crisis.

Finally, two other problems which must be considered. Foreign ownership jeopardizes the integrity of bilateral air transport negotiations between the United States and foreign governments. International routes are traded by nations on a bilateral basis, usually with candid input from their carriers. Multiple allegiances may well jeopardize the integrity of that process.

Moreover, the major European governments own and subsidize Airbus. At a time when our domestic manufacturing industry (which, by the way, is our single most important manufacturing export) is suffering terribly, we must be careful that European governments which own sizeable blocks of European airlines, which are allowed to buy sizeable blocks of U.S. airlines, do not influence those U.S. airline to buy European, as opposed to U.S., aircraft.

Mr. BROOKS. I thank all the witnesses for their comprehensive and informative testimony.

The American people have had a full 15 years in the brave new world of a deregulated airline industry. That experience has been more akin to a roller coaster ride than the smooth and comfortable flight that the proponents of deregulation predicted.

In this industry, as in so many others during the Reagan-Bush era, we have learned the sad truth that deregulation is not a panacea, that anticompetitive practices can follow when both the regulator and the antitrust enforcer have left their posts.

As chairman of the committee that oversees the operation of the antitrust laws, I intend to follow very closely the work of the President's Commission just recently appointed. When it comes to competition in this vital sector of the American economy, there is no such thing as an automatic pilot.

The hearing is adjourned. I thank you.

[Whereupon, at 12:45 p.m., the subcommittee adjourned.]

## A P P E N D I X E S

### APPENDIX 1.—MATERIAL SUBMITTED FOR THE HEARING RECORD

## BRITISH AIRWAYS

May 21, 1993

Commercial & Government Affairs, A  
1850 K Street, NW  
Suite 800  
Washington, DC 20006  
Tel: 202/737-9000

### TOWARD OPEN SKIES: BRITISH AIRWAYS' VIEWS CONCERNING INTERNATIONAL AVIATION POLICY\*

U.S. policymakers, including the newly-appointed Members of the National Commission to Ensure a Strong Competitive Airline Industry, must address a number of vital, inter-related issues of international aviation policy at a time of great change in the industry.

In recent years, the markets for trade in goods and services have become increasingly global in scope. International air transportation services must expand to support this growth in trade. In a nutshell, the problem is that the need for international travel has *outgrown* the system that was established to regulate it — a system comprised of restrictive bilateral agreements and national regulation that is based on notions of reciprocity and narrow, and in some cases outdated, conceptions of national interest.

British Airways supports a fundamental reevaluation of the current regulatory system — and supports replacing it with a fully liberalized regime in which the free market, and not government or inter-government regulation, determines what international routes may be served, by which carriers, and at what prices.

At present, restraints on free competition in international air service include not only bilateral restrictions on routes, designations and frequencies, but also nationalistic limitations on foreign investment. As the market for air transportation services becomes more global, limits on foreign investment interfere with the ability of carriers of all countries to raise new capital, access foreign routes, and establish cross-border alliances in ways that may be necessary to compete in this market. Only when all such restrictions are liberalized will we have free market access and true open skies.

A true open skies regime is essential for supporting continued growth in world trade, and continued economic development in the U.S. and throughout the world. At bottom, the goals of U.S. international aviation policy should be to make international air service more widely available, and to increase competition, improve service and lower prices on the routes that are served, for the benefit of states, municipalities, businesses, and the traveling public. This in turn requires measures to build a strong and stable airline industry.

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\*The following material was prepared by the firm of Powell, Goldstein & Murphy, Powell, Goldstein & Murphy registered as a foreign agent with the U.S. Department of Justice. Copies of these materials and the firm's registration statement are available for public inspection at the U.S. Department of Justice. Registration as a foreign agent does not indicate U.S. Government approval of the content of this material.



British Airways PLC  
Reconstructed after  
Standard Gauge  
Gothic Aircraft  
Dimensions 34 x 25  
Issued in England No. 1777

The challenge facing U.S. policymakers is thus to step back from the debate as it has been framed to date, think broadly about the goals of the international aviation system, and work with U.S. trade partners to develop a way to a better future for the industry.

#### British Airways PLC

Since it was privatized in 1987, British Airways has developed into a well-managed, profitable international carrier, ranked 6th in 1991 in terms of revenue passenger miles, behind American, United, Delta, Northwest and Continental.

British Airways is one of the few European carriers of any size without either government ownership or subsidy. In keeping with trends in the industry, it is expanding globally — including in the U.S., where it has acquired an approximately 25% interest in USAir, and is in the process of implementing a code-share relationship with that carrier.

British Airways is also a major export customer for U.S. aircraft manufacturers. In all, 82% of British Airways' fleet is U.S. manufactured. In fact, British Airways is Boeing's largest export customer. All of its outstanding orders, valued at more than \$18.8 billion, are for Boeing aircraft. British Airways is a launch customer for Boeing's new B777 aircraft, but also for GE's new big GE90 engines which will power the B777. Outstanding orders for GE engines total \$823 million.

#### Transformation of Aviation Markets

The starting point for any analysis of current international aviation policy issues, and current pressures on U.S. bilateral relationships in Europe and the Pacific, is to recognize that three fundamental developments have transformed international aviation markets in recent years:

1. Increasing Globalization. As demand for international air travel has increased, carriers of all countries have sought to expand their international operations in an effort to compete for these passengers effectively and efficiently — adding international routes, and making equity investments in and strategic alliance with carriers in other countries. Competition in aircraft manufacturing has become global as well; U.S. airframe and engine manufacturers have come to depend increasingly on sales to foreign carriers.
2. Emergence of U.S. Hub System. At the same time, as a result of the combined effects of demographics and deregulation, a vast and commercially significant

system of hub-and-spoke networks has developed in the U.S. The hub has literally become the primary instrument of competition in this industry.

3. **Increasing Industry Concentration.** Meanwhile, smaller, innovative carriers have been squeezed out of the market, either ceasing operations or merging into one of the larger carriers. Since 1979, the number of major U.S. carriers has decreased from 23 to 10, and the capacity share of the Big Three has increased from 38% to nearly 60%.

#### Increasing U.S. Share of International Markets

This transformation of the market, together with success in bilateral negotiations with U.S. trading partners, cost advantages and other factors, have resulted in an increasing U.S. share in international aviation markets. From 1979 to 1992, the share of flights of U.S. carriers in the U.S./France market has increased from 45% to 70%; 49% to 57% in the U.S./U.K. market; and 29% to 59% in the U.S./Germany market.

The key reason U.S. carriers dominate international travel is that they can now combine strong international route systems with U.S. domestic hub systems they dominate – hub systems that owing to restrictions on inward investment are protected under U.S. law from competition from abroad. This has been particularly true since 1991, when American, United and Delta purchased international routes systems from TWA and Pan Am.

U.S. carriers have a distinct advantage in competing for international travelers who wish to travel to or from a city behind their U.S. gateway/hubs, because such travelers generally prefer to remain on one carrier throughout their journey.<sup>v</sup> By dominating most of their U.S. hubs, U.S. carriers enjoy other advantages over foreign carriers, as well, even for gateway-to-gateway traffic. Code-sharing arrangements between U.S. and U.K. carriers only go part way to redressing this imbalance – two distinct carriers responsible to two different sets of shareholders cannot hope to coordinate their U.S. and transAtlantic services as efficiently and effectively as United, American or Delta.

Because of demographic factors, hub systems are not nearly as significant in Europe as they are in the U.S., and they do not funnel traffic into transAtlantic routes to the same degree as in the U.S. And hubs in Europe tend not to be dominated by any

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<sup>v</sup> For example, of the 3 million U.S.-U.K. passengers who need to make a connection in the U.S., only 21% chose a British carrier for their transAtlantic journey. By contrast, 41% of the 2.5 million passengers needing a connection in London use a U.S. carrier for the transAtlantic leg.

one carrier. While Delta accounts for 80% of all departures from Atlanta, for example, British Airways accounts for only 37% of departures from Heathrow.

The Big Three thus enjoy a significant, legally protected advantage over their foreign competitors in competing for international traffic to and from the U.S. — and greater market access, as compared with their foreign competitors.

#### Key International Policy Issues

A number of current policy problems that may appear initially to be unrelated, are thus related to one another and to these fundamental market developments:

- How to expand air service to U.S. states and cities and support, rather than retard, economic growth.
- How to reconcile the increasing number and variety of airline cross-border acquisitions, equity investments and alliances with existing national restrictions on foreign investment in domestic airlines, and modify those laws so that legitimate national interests may be protected by the least restrictive means.
- How to maintain airline competition within the U.S., given the needs of second tier carriers for new capital and access to international markets;
- How to address increasing friction between the U.S. and its European and Pacific trading partners over the increasing dominance of the Big Three in international air travel;
- How to increase access of U.S. carriers and carriers of other countries to international aviation markets;
- How to guard against predatory pricing and other anticompetitive practices in international markets; and
- How to strengthen the U.S. aircraft manufacturing industry.

#### Policy Approach

In this environment, the challenge for U.S. policy-makers is to work with U.S. trading partners in Europe and elsewhere to make the very significant adjustments to U.S. and foreign regulatory structures that are necessary to provide greater access to

international aviation markets, and expanded and improved service, for the benefit of the traveling public, affected communities and airlines of all countries:

- A complete solution probably cannot be achieved immediately or in a single step.
- The U.S. should not view these issues in isolation from one another.
- These issues cannot be resolved unilaterally. The U.S. must take into account the views and interests of its trading partners, and develop consistent, mutually beneficial strategies for change.
- The broad goal should be orderly progress, through interim phases, toward an open market regime, with all restrictions eventually removed in all countries that unfairly or inappropriately impair competition, including foreign investment restrictions;
- The U.K. and the U.S. can play a key role, working together, because they are the most committed to more open markets as a goal. Other countries can learn from their example.

### Conclusions

British Airways thus believes that increasing the access of both U.S. and U.K. carriers to the U.S./U.K. market via a phased, balanced liberalization of both the Bermuda 2 restrictions on routes, designations and frequencies and limitations on foreign investment must be a part of any "open skies" process.

Lifting U.S. restrictions on foreign investment would also benefit numerous U.S. constituencies, including second tier U.S. carriers, their employees, the communities they serve, and the traveling public via increased competition in both domestic and international markets.

The negotiation over changes to the U.S./U.K. bilateral aviation agreement are off to a constructive and positive start in this regard. In the joint statement released following their initial meeting on April 19, Secretary Pena and U.K. Transport Secretary John MacGregor confirmed that while it would require "significant changes and difficult decisions on both sides," they shared a "common aim of liberalizing the air services agreement" and replacing it with "a regime that enables airline managements to determine the price and supply of air services." Official talks opened with a productive session in London on May 5-7, and are planned to continue in Washington on June 16-17. British Airways is hopeful that these market access talks can be concluded quickly and successfully.

STATEMENT OF JEFFREY W. ERICKSON,  
PRESIDENT AND CHIEF EXECUTIVE OFFICER OF RENO AIR, INC.  
BEFORE THE SUBCOMMITTEE ON ECONOMIC AND COMMERCIAL LAW  
OF THE HOUSE COMMITTEE ON THE JUDICIARY

As a recent entrant, Reno Air, Inc., an air carrier headquartered in Reno Nevada, has a direct and immediate stake in the future of competition in the airline industry. Reno Air has also learned, through its own experience, that in some circumstances the government must intervene to foreclose predatory behavior, thereby allowing competition to flourish, so that the public can receive the service they need, at competitive fares.

The post deregulation environment has not been kind to companies which have sought to enter the airline business. When Congress passed legislation last fall to establish a National Commission to study the airline industry, it found that:

Because of the airline industry's financial distress and the absence of government policies to promote competition, there has been a precipitous decline in the number of major airlines. Of the 22 airlines which entered the industry following airline deregulation, only 2 are now operating.<sup>1</sup>

In addition, Congress found that "[c]oncentration in the airline industry has advanced rapidly in the past few years", and that further concentration "could leave the industry without sufficient competition to ensure a continuation of the benefits consumers have received under airline deregulation."<sup>2</sup>

Recognizing the difficulties small carriers have had in taking on entrenched incumbents directly, Reno has sought to create a niche for itself by providing innovative service in underserved markets. Reno Air offers nonstop service between Reno and Seattle, Portland, San Francisco, Los Angeles, San Diego, and Ontario, California, and one-stop and connecting service between those cities via Reno using ten McDonnell-Douglas MD-80 aircraft. Reno also recently announced service between San Jose, California and San Diego, Los Angeles, Ontario, Portland, and Seattle, and between San Francisco and Portland and Seattle.

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<sup>1</sup> Airport and Airway Safety Act of 1992, Pub. L. 102-581 § 204(a)(4), 106 Stat. 4891.

<sup>2</sup> Id., § 204(a)(5), (7).

Reno Air has designed its route structure and pricing primarily to attract new traffic, by providing low-cost service without burdensome restrictions in markets which are currently underserved. More than three-quarters of Reno Air's passengers to date have been "stimulated" passengers. In other words, they are passengers who likely would not have flown at all had their demand not been "stimulated" by Reno's innovative service.

Reno Air offers two classes of service, at fares considerably lower than those of competing carriers. Unlike other carriers, Reno offers its low fares on a one-way basis. Reno also offers much lower walkup and full coach fares than its competition, allowing customers the advantage of low fares without advance purchase restrictions. On advance purchases, Reno's fares offer the unique advantages of not requiring a Saturday stay-over requirement or a last ticket date. Reno Air is able to offer low cost service because its costs of providing service are very low relative to most other carriers.

So far Reno Air's strategy has been effective. Reno had a positive cash flow in its second week of operations, and achieved profitability in the second month. For the first three months of 1993, Reno Air's load factor was almost 72%, the highest in the industry. Reno posted an operating profit for those three months of \$2.3 million, and a net profit of \$1.8 million.

As Reno has sought to expand its service to new markets, however, it has encountered head-on some of the competitive barriers which have plagued other carriers trying to bring new competition to the airline industry. The most prominent example was Reno's experience when it announced it was instituting service from Reno to Minneapolis-St. Paul, an airport dominated by Northwest Airlines. Northwest first responded by announcing a competing Reno-Minneapolis service, even though it had recently withdrawn from the route because it was losing money at fares far higher than Reno was proposing. (Reno Air announced fares in the market of \$95 and \$125 one way, as compared to Northwest's lowest available fare of \$405 for a nonrefundable round trip ticket when it last offered service.)

When Reno formally announced its service in February of this year, Northwest responded by matching Reno's fares on the Minneapolis-Reno route. These were fares at which Northwest, with its higher cost structure, could not hope to make a profit. Northwest also announced it was opening its own "mini-hub" at Reno to overlay most of Reno's traffic. Northwest then announced it would underprice Reno Air's proposed Minneapolis - West Coast service not only on its connecting service through Reno, but also on its non-stop flights to Los Angeles and Seattle.

Northwest's sole reason for responding as it did was to warn Reno Air away from the Minneapolis-St. Paul market. Northwest had no service whatsoever in Reno, and its proposed Reno-West Coast routes made no sense as part of Northwest's route structure. Northwest's actions had no legitimate competitive justification, but rather were designed to raise Reno's costs of entry into Minneapolis so high that Reno would withdraw and leave Northwest with its monopoly unchallenged. Indeed, Northwest could not profitably serve even the Minneapolis-Reno market, as its own experience two years previously had shown. Reno thus believed quite strongly that Northwest's actions constituted monopolization and attempted monopolization in violation of the antitrust laws.

Reno Air's finances and managerial resources would have been badly strained by bringing its own antitrust enforcement action. Moreover, Reno needed prompt action to prevent Northwest's proposed actions from damaging the company. Accordingly, we took our case to the federal enforcement authorities.

The Justice Department had previously undertaken an economic analysis which concluded that Northwest possessed monopoly power at Minneapolis as a result of its 1986 merger with Republic, a merger which the Justice Department had opposed.<sup>3</sup> Moreover, the Department of Transportation had expressed its intention to move more aggressively against anticompetitive actions in the airline industry. After Secretary Pena expressed concern over Northwest's actions, and after the Department of Justice opened its own investigation into the matter, Northwest announced it was withdrawing its proposed Reno-West Coast service.

Northwest did begin its Minneapolis-Reno Service, at fares which matched Reno's. When Reno announced it would withdraw from the market to pursue opportunities on the West Coast, Northwest withdrew its matching fares and instituted a higher fare structure for its Reno-Minneapolis service. This confirms our belief that Northwest's intent was not to provide low cost

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<sup>3</sup> R. Willig, Antitrust Lessons From The Airline Industry: The DOJ Experience, 60 Antitrust L. J. 695, 702-03 (1992) ("In 1986, mergers between TWA and Ozark, and between Northwest and Republic Airlines were permitted to proceed, over the protests of the Department of Justice, by the Department of Transportation, which had final authority over airlines mergers at the time . . . As described and documented in an excellent study by Antitrust Division economists, the results of these actual mergers (unhappily for the public interest) confirmed the antitrust analysis. . . The Northwest-Republic merger significantly raised price and significantly curtailed service out of Minneapolis-St. Paul.").

service, but to drive Reno from the market with predatory fares and recover its losses through higher prices once Reno exited.

We believe that the government's willingness to take action in response to Northwest's actions provides a welcome signal that it will move aggressively to prevent predatory behavior on the part of larger carriers which threatens new entry. In airline markets, as in other markets, new entry, or the possibility of new entry, is one of the single most important factors in keeping markets competitive.<sup>4</sup> If new entrants are to have this salutary effect, however, they must be given a chance to compete, and to succeed or fail on the merits.

Vigorous antitrust enforcement can help new entrants such as Reno Air combat private restraints of trade, such as we faced in the Northwest situation. Unfortunately, Reno has also faced policies of the government itself which have restrained our ability to compete. We believe these should be addressed as a part of any effort to assure competition in the airline industry.

Deregulation was premised on the assumption that new carriers could enter an airline market relatively quickly and easily if existing carriers were charging too much or offering inadequate service. However, in practice airport gates and facilities are limited at a number of airports, requiring new entrants in many cases to deal with the very incumbent carriers who will be their main competitors. In Minneapolis, for example, we were forced to deal with Northwest-controlled entities for fueling arrangements and other services; as a result, they insisted on provisions which had the effect of either increasing the price of our entry, or our fuel costs.

Moreover, through slot allocation restrictions, access to several key airports is essentially denied to new entrants. Reno has attempted unsuccessfully for months to obtain usable slots at Chicago's O'Hare airport. As Reno has learned, expansion into the Midwest is extremely difficult without service to Chicago. Although Congress has previously taken steps to address the slot problem by providing new entrants a preference in lotteries for unused slots, and by protecting small carriers from withdrawal of slots, these measures have not provided any relief to Reno Air at

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<sup>4</sup> The Department of Justice's merger guidelines treat the ease of entry as a particularly important factor in assessing the competitive performance of concentrated markets. § 3.3. See United States v. Waste Management, Inc., 743 F.2d 976 (2d Cir. 1984) ("ease of entry constrains . . . every firm in the market. Should [defendant] attempt to exercise market power by raising prices, none of its smaller competitors would be able to follow the price increases because of the ease with which new competitors would appear.").

O'Hare, where no slots are available. We appreciate the FAA's announced intention to review its slot allocation policies, but we stress that any such review must promptly and effectively address the need to provide slots to new entrants at slot constrained airports.

Governmentally-imposed restrictions also have affected our ability to provide international service. Reno Air wants to provide service between Reno and Vancouver, British Columbia, but has been prevented from doing so by restrictions in our bilateral aviation agreement with Canada. Reno has been prevented from providing scheduled service in this market even though Canadian carriers offer charter service very similar to scheduled service, and even though a Canadian scheduled carrier has recently been approved under local and regional note agreements between the two countries. We believe that the Department of Transportation should pay particular attention to the competitive benefits of new entrants in making its international route decisions, and that this would be a useful area for the competition advocacy program of the Department of Justice as well.

In short, although innovative companies such as Reno Air can find a place in the current aviation market, the risks for new entrants are significant. Antitrust enforcement must assure that everyone has a fair chance to compete. In addition, governmental policies should be revised to encourage new entry, or, at the very least, revised so that they do not restrict it.

Thank you.

## TESTIMONY OF

DEE MAKI, NATIONAL PRESIDENT  
ASSOCIATION OF FLIGHT ATTENDANTS, AFL-CIO

CHAIRMAN BROOKS, MEMBERS OF THE SUBCOMMITTEE: THANK YOU FOR THIS OPPORTUNITY TO TESTIFY AT THIS IMPORTANT HEARING ON THE AIRLINE INDUSTRY AND THE ADEQUACY OF COMPETITION. MY NAME IS DEE MAKI AND I AM THE NATIONAL PRESIDENT OF THE ASSOCIATION OF FLIGHT ATTENDANTS, AFL-CIO. I AM HERE TODAY ON BEHALF OF THE 33,000 FLIGHT ATTENDANTS WE REPRESENT AT 21 U.S. CARRIERS. I INTEND TO DISCUSS COMPETITION AND THE FINANCIAL CONDITION OF THE INDUSTRY FROM THE PERSPECTIVE OF THOSE FLIGHT ATTENDANTS.

I WILL FIRST ADDRESS THE ISSUE OF THE ADEQUACY OF COMPETITION IN THE AIRLINE INDUSTRY AND THEN TURN TO THE QUESTION OF THE INDUSTRY'S FINANCIAL CONDITION. TO PUT IT BLUNTLY, COMPETITION IN THE AIRLINE INDUSTRY IS A MYTH. OF COURSE THERE IS A MEASURE OF COMPETITION IN CERTAIN KEY MARKETS -- THERE WILL ALWAYS BE SEVERAL CARRIERS FIGHTING OVER PASSENGERS BETWEEN NEW YORK AND LOS ANGELES FOR EXAMPLE, AT LEAST I HOPE SO. BUT THE STORM OF COMPETITION FORECAST BY THE PROONENTS OF DEREGULATION OVER 14 YEARS AGO IS SCARCELY A MEMORY. THE PROONENTS OF DEREGULATION STILL TALK ABOUT COMPETITION AND MAINTAIN THIS FICTION THAT THE INDUSTRY AND THE CONSUMERS ARE BETTER OFF TODAY. THAT FICTION IS BETRAYED BY AIRLINE MANAGERS WHO, WHILE PONTIFICATING ENDLESSLY IN PUBLIC ABOUT THE BENEFITS OF DEREGULATION FOR THE CONSUMER, SPEND MOST OF THEIR WAKING HOURS PURSUING "MARKET SHARE."

WHAT DOES THIS QUEST FOR "MARKET SHARE" MEAN TO CONSUMERS? IT MEANS THAT MANAGEMENT OF THE THREE MOST AGGRESSIVE U.S. CARRIERS

(AMERICAN, DELTA AND UNITED) HAVE SUCCEEDED IN GAINING CONTROL OF OVER 54 PERCENT OF THE DOMESTIC MARKET. IT MEANS THAT OVER 90 PERCENT OF THE MARKET IS CONTROLLED BY JUST EIGHT CARRIERS. ALONG THE WAY THE INDUSTRY HAS SEEN OVER 50 MERGERS AND OVER 200 AIRLINES HAVE FILED FOR BANKRUPTCIES OR CEASED OPERATIONS SINCE 1978, WITH MORE TO COME. IT IS UNDENIABLE THAT THE INDUSTRY IS MORE MONOPOLISTIC TODAY THAN IT WAS BEFORE DEREGULATION.

IN 1978, PRIOR TO THE ADVENT OF DEREGULATION, THE THREE LARGEST CARRIERS CONTROLLED 47 PERCENT OF THE MARKET AND THE TOP EIGHT CARRIERS SHARED ONLY 80 PERCENT OF THE MARKET, NOT THE CURRENT 91 PERCENT. COMPETITION HAS COME AND GONE IN THIS INDUSTRY. IT REMAINS ONLY AS AN EXCEPTION TO THE RULE OF MARKET DOMINATION.

FOLLOWING DEREGULATION, AS THE INDUSTRY BECAME MORE CONCENTRATED THE SURVIVING CARRIERS BEGAN TO REPLACE LOW FARES WITH WHAT THEY CALLED "RATIONAL PRICING." CONSUMERS CALLED THIS "NON-COMPETITIVE PRICING," BECAUSE NO MATTER WHICH AIRLINE THEY CALLED THEY WERE FACED WITH NEW, DRAMATICALLY HIGHER FARES. CARRIER EXECUTIVES SPOKE IN DEROGATORY TERMS OF PRICE COMPETITION DESPITE HAVING PROMISED CONSUMERS LOW FARES AS THE STANDARD FOR DEREGULATION. WITH INCREASING MARKET SHARE, ACHIEVED SOMETIMES AT THE EXPENSE OF LOW-FARE NEW ENTRANTS, CARRIERS WERE ABLE TO END FARE WARS AND "RATIONALIZE" FARES, WITH IMPUNITY IN SOME MARKETS. FOR EXAMPLE, WHEN EASTERN AIRLINES FINALLY CEASED OPERATIONS, OTHER CARRIERS RAISED FARES DRAMATICALLY IN EASTERN'S FORMER

MARKETS THE VERY NEXT DAY.

LIKE COMPETITION IN GENERAL, PRICE COMPETITION SURVIVES ONLY AS A MYTH. WHEN AIRLINE EXECUTIVES ARE NOT TRYING TO PERPETUATE THE MYTH OF COMPETITION, THEY HAVE AN ENTIRELY DIFFERENT APPROACH TO PRICING. IN THEORY, PRICING IS FAIRLY SIMPLE IN THE AIRLINE INDUSTRY: AIRLINES ATTEMPT TO CHARGE THE HIGHEST POSSIBLE PRICE FOR EACH SEAT AT THE TIME IT IS SOLD AND STILL HAVE THE AIRCRAFT DEPART WITH EVERY SEAT FILLED. MASSIVE COMPUTER RESERVATION SYSTEMS HAVE ALLOWED THIS TO BE REFINED TO A HIGH ART IN PRACTICE. TO SAY THAT EVERY SEAT SOLD FOR LESS THAN "FULL FARE" IS A "DISCOUNT" FARE IS MEANINGLESS. IN REALITY, THAT "FULL FARE" IS ONLY WHAT THE AIRLINE CHARGES FOR THE LAST FEW SEATS THAT IT KNOWS IT CAN SELL AT THE LAST MINUTE BEFORE DEPARTURE TO PASSENGERS WHO MUST TRAVEL DESPITE THE HIGH FARE. BY COMPARISON, THE SO-CALLED "DISCOUNT" FARES ARE NEVERTHELESS THE HIGHEST FARE THE AIRLINE BELIEVES IT CAN CHARGE AND STILL SELL TICKETS ON A GIVEN DAY IN ADVANCE OF DEPARTURE. I WOULD VENTURE TO SAY THAT ALMOST NO TICKETS ARE SOLD AT A TRUE DISCOUNT BELOW THE HIGHEST FARE THE AIRLINE BELIEVES IT CAN CHARGE ON A GIVEN DAY. DISCOUNT FARES AND PRICE COMPETITION ARE LITTLE MORE THAN MYTHS.

MORE RECENTLY, THE INDUSTRY HAS EXPERIENCED A DESTRUCTIVE RETURN TO FARE WARS. PRICING FARES TO STIMULATE AT LEAST SOME REVENUE IN THE FACE OF DECLINING TRAFFIC, SOME CARRIERS HAVE NEARLY PRICED THEMSELVES OUT OF BUSINESS. SOME BLAME OVERCAPACITY,

OTHERS SEE THIS AS AN ATTEMPT TO DRIVE STILL MORE AIRLINES OUT OF THE INDUSTRY. THE NET EFFECT IS DISASTER FOR THE AIRLINES, AIRLINE WORKERS AND THE TRAVELING PUBLIC.

EVEN THE TALK OF A RETURN TO "SERVICE COMPETITION" HAS FADED AFTER A BRIEF ASCENDANCY A FEW YEARS AGO, AN EARLY VICTIM OF DECLINING PROFITS. SINCE THEY NO LONGER COULD BRAG THEY WERE COMPETING FOR PASSENGERS BY OFFERING LOW, COMPETITIVE FARES, AIRLINE EXECUTIVES BEGAN TO TALK ABOUT COMPETING BY OFFERING BETTER SERVICE. THERE WAS A LOT OF TALK ABOUT SERVICE COMPETITION AROUND THE INDUSTRY AT THE TIME, AND PASSENGERS MAY EVEN HAVE NOTICED A SMALL IMPROVEMENT IN SERVICE FOR AWHILE. BUT ANYONE WHO HAS EATEN A DEREGULATED AIRLINE MEAL LATELY, IF IN FACT YOU RECEIVED A MEAL AT ALL, HAS REALIZED THAT SERVICE HAS DECLINED DRAMATICALLY.

BEFORE DEREGULATION BECAME THE LAW, AND STILL AFTER ITS PASSAGE, LABOR SPOKE VERY CLEARLY TO THE NEGATIVE IMPACT DEREGULATION WAS TO HAVE. IN 1983 AT A HEARING BEFORE THE HOUSE AVIATION SUBCOMMITTEE OF THE PUBLIC WORKS AND TRANSPORTATION COMMITTEE, FORMER AFA PRESIDENT LINDA PUCHALA SAID:

"DEREGULATION HAS OCCURRED AT THE EXPENSE OF AIRLINE EMPLOYEES WHO HAVE EXPERIENCED FURLoughs, BEEN TRANSFERRED..., AND ACCEPTED PAY CUTS AND WORK RULE CONCESSIONS. TOO MANY EMPLOYEES HAVE ALSO SUFFERED THE ULTIMATE

LOSS OF THEIR JOBS TO BANKRUPTCY.

WE ARE SKEPTICAL OF ANY PREDICTION FOR A TURNABOUT IN THE NEAR FUTURE...THERE ARE LIKELY TO BE ADDITIONAL MERGERS, THE EMERGENCE OF MORE LOW COST CARRIERS, CONTINUING EXCESS CAPACITY AND FARE WARS WHICH WILL DEPRESS YIELDS, CONTINUED HIGH LEVELS OF UNEMPLOYMENT, AND POSSIBLY THE DEMISE OF ONE OR MORE FINANCIALLY MARGINAL AIRLINES."

ALTHOUGH SHE SPOKE A MERE FIVE YEARS INTO THE DEREGULATED ERA, PRESIDENT PUCHALA WAS ABLE TO SEE THE DESTRUCTION THAT HAD BEEN WROUGHT, AND YET COULD SCARCELY HAVE KNOWN THAT THE FUTURE WOULD PROVE EVEN MORE DEVASTATING FOR FLIGHT ATTENDANTS THAN SHE PREDICTED.

SINCE DEREGULATION AIRLINE MANAGMENTS HAVE FOUND INGENIOUS WAYS TO WRECK WHAT HAD BEEN THE GREATEST AIR TRANSPORT SYSTEM IN THE WORLD. SIMPLE BAD MANAGEMENT RESULTED IN THE DESTRUCTION OF SEVERAL SIGNIFICANT AIRLINES. A NEVER ENDING STREAM OF MERGERS AND ACQUISITIONS SWALLOWED UP OTHERS. ADVERSARIAL, EVEN BELLIGERENT, ATTITUDES TOWARD LABOR HAVE DESTROYED SOME WHILE AFFECTING ALL.

LET ME TURN NOW TO THE ISSUE OF THE CURRENT FINANCIAL CONDITION OF THE AIRLINE INDUSTRY. ONE WOULD HOPE THAT, WITH LESS

COMPETITION AND RISING FARES, THE FINANCIAL CIRCUMSTANCES OF THE REMAINING CARRIERS WOULD BE PROMISING. UNFORTUNATELY, WITH FEW EXCEPTIONS, THAT IS NOT THE CASE.

FOR TOO LONG THE PRESS HAS BEEN REPORTING MAMMOTH LOSSES IN THE AIRLINE INDUSTRY. THE DEREGULATED ERA WAS FIRST AN ERA OF WILD SWINGS BETWEEN PROFIT AND LOSS AND NOW HAS TURNED TO A PERIOD OF CATASTROPHIC LOSSES. WE ARE ALL FAMILIAR WITH THE NET LOSS NUMBERS FROM 1992. FOR THE BIG THREE CARRIERS, AMERICAN, DELTA AND UNITED, NET LOSSES TOTALED NEARLY \$2.5 BILLION. ONLY SOUTHWEST AIRLINES NETTED A PROFIT IN 1992. IN ADDITION, IN 1991 AND 1992 ALONE, FIVE CARRIERS CEASED OPERATIONS (BRANIFF, EASTERN, EASTERN METRO EXPRESS, MIDWAY AND PAN AM) AND FIVE OTHERS FILED FOR BANKRUPTCY (AMERICA WEST, MARKAIR, METRO, STATESWEST AND TRANS WORLD AIRLINES).

ADD THESE LOSSES TO THE DOZENS AND DOZENS OF MERGERS AND ACQUISITIONS THAT AFA-REPRESENTED FLIGHT ATTENDANTS HAVE EXPERIENCED SINCE DEREGULATION AND THE PICTURE BECOMES FRIGHTENING. EACH BANKRUPTCY, EACH MERGER AND ACQUISITION, EACH FINANCIAL CRISIS WAS BROUGHT ON, IN PART, BY POOR MANAGEMENT. THIS HAS EXACTED A VERY HEAVY TOLL ON THE FLIGHT ATTENDANTS AND OTHER WORKERS IN THE FORM OF LOST WAGES, DISLOCATION, AND LOST JOBS.

CARRIERS THAT ARE STRUGGLING FINANCIALLY OFTEN HAVE COME TO THEIR

WORKERS DEMANDING CONCESSIONS TO HELP COVER THEIR FINANCIAL PROBLEMS. APPROXIMATELY 36,000 FLIGHT ATTENDANTS--OVER ONE-THIRD OF THE WORKFORCE--HAVE BEEN DIRECTLY AFFECTED BY THESE CUTS. DURING THE LAST TWO YEARS ALONE, THE FOLLOWING CARRIERS HAVE ASKED THEIR FLIGHT ATTENDANTS FOR CONCESSIONS:

\*ALASKA - NOW IN NEGOTIATIONS (SINCE 1990), ALASKA IS ASKING FOR SIGNIFICANT CUTS IN PENSION, MEDICAL BENEFITS AND WORKRULES FROM ITS FLIGHT ATTENDANTS. THE NATIONAL MEDIATION BOARD STARTED A 30-DAY COOLING-OFF PERIOD ON MAY 19.

\*ALOHA - IN EARLY FEBRUARY 1993, THE COMPANY ASKED ITS WORKERS, INCLUDING ITS FLIGHT ATTENDANTS, TO REOPEN THEIR LABOR CONTRACT IN ORDER TO GIVE BACK A FIVE PERCENT WAGE INCREASE WHICH HAD JUST BEEN IMPLEMENTED FEBRUARY 1ST, TO ACCEPT A FREEZE ON LONGEVITY INCREASES, AND TO ACCEPT A SMALLER PENSION CONTRIBUTION.

\*CONTINENTAL - IN JUNE 1992 FLIGHT ATTENDANTS AGREED TO A PAY FREEZE AT 1989 RATES UNTIL 1994. THIS AGREEMENT WAS PART OF THEIR FIRST COLLECTIVE BARGAINING CONTRACT SINCE THE COMPANY IMPLEMENTED WAGES AND WORK RULES IN 1983 FOLLOWING THE STRIKE AND BANKRUPTCY.

\*DELTA - MANAGEMENT IMPLEMENTED A FIVE PERCENT WAGE CUT EFFECTIVE FEBRUARY 1, 1993 ON ITS NON-UNION FLIGHT ATTENDANTS.

\*HAWAIIAN - ONCE OR TWICE A YEAR FOR THE PAST SEVERAL YEARS, HAWAIIAN MANAGEMENT HAS ASKED ITS FLIGHT ATTENDANTS AND OTHER UNION GROUPS FOR CONCESSIONS TO ASSIST THE COMPANY IN ATTRACTING

NEW EQUITY INVESTORS, REFINANCING ITS DEBT, AND OTHER STRATEGIES TO AVOID BANKRUPTCY.

\*NORTHWEST - FLIGHT ATTENDANTS, REPRESENTED BY THE INTERNATIONAL BROTHERHOOD OF TEAMSTERS, HAVE REACHED A TENTATIVE AGREEMENT REGARDING THE COMPANY'S DEMAND FOR WAGE/SALARY CUTS FROM ALL ITS UNIONS OF \$900 MILLION OVER THREE YEARS.

\*TWA - IN AUGUST OF 1992, FLIGHT ATTENDANTS, REPRESENTED BY THE INDEPENDENT FEDERATION OF FLIGHT ATTENDANTS, AGREED TO A NET 11 PERCENT CUT IN WAGES AND WORKRULE CHANGES AS PART OF A "TURN AROUND PLAN" TO ASSIST THE COMPANY'S EMERGENCE FROM BANKRUPTCY.

\*UNITED - IN JANUARY 1993, UNITED ASKED ITS FLIGHT ATTENDANTS AND OTHER UNIONS TO REOPEN THEIR LABOR CONTRACTS. FROM THE AFA CONTRACT THAT WAS SIGNED AT THE END OF 1991, THE COMPANY ASKED AFA TO WAIVE A FOUR PERCENT WAGE INCREASE SCHEDULED FOR MARCH, TO ACCEPT A FREEZE ON LONGEVITY INCREASES, AND TO ASSUME A LARGER SHARE OF MEDICAL INSURANCE COSTS. AFA REFUSED THE REQUEST, AS DID THE OTHER UNIONS.

\*USAIR - IN NEGOTIATIONS (SINCE 1989), THE COMPANY HAD DEMANDED PAY CUTS AND WORKRULE CHANGES. A NEW AGREEMENT WAS RECENTLY RATIFIED BALANCING PRODUCTIVITY IMPROVEMENTS AND PAY CONCESSIONS WITH LONG-TERM IMPROVEMENTS IN PAY AND OTHER AREAS.

THIS DOES NOT BEGIN TO MEASURE THE IMPACT ON FLIGHT ATTENDANTS WHO HAVE SUFFERED THROUGH FURLoughS, TRANSFERS, AND OUTRIGHT JOB LOSS. ACCORDING TO THE FUTURE AVIATION PROFESSIONALS OF AMERICA (FAPA), IN FEBRUARY OF 1992, 2,137 FLIGHT ATTENDANTS WERE

FURLoughed. This includes the 1,100 Pan Am flight attendants who lost their jobs when the company ceased operations in December of 1991. Last month, FAPA lists 1,442 furloughed flight attendants. And yet, even these immense sacrifices by flight attendants have done little to stop the bankruptcies and mergers.

Moving into 1993, the potential for further furloughs or job losses is tremendous. A perfect example of the sorry state of today's airline industry is the recently announced break up and sale of Air Wisconsin. United bought Air Wisconsin in order to acquire their very valuable slots at Chicago's O'Hare airport. After operating Air Wisconsin for only 10 months, United announced, and is now proceeding with, the dismantling of the carrier -- selling it piecemeal and keeping only the O'Hare slots.

In response to my union's concerns about the flight attendants, many of whom have worked for Air Wisconsin for decades, United answers that this sale is "assets only." "Assets only" is the root of the problem with today's airline industry. This transaction is illustrative of an industry that functions on an assets-only basis, without concern for dedicated employees or the public it serves.

In addition to reducing competition, mergers and acquisitions have loaded many of the surviving carriers with so much debt that

THEIR CONTINUING VIABILITY IS THREATENED. CONTINENTAL, USAIR, TWA, AND NORTHWEST, AMONG OTHERS, HAVE LEVELS OF DEBT THAT SEVERELY LIMIT THEIR ABILITY TO WEATHER A DOWNTURN IN THE MARKET OR A CONTINUED RECESSION IN THE GENERAL ECONOMY. FURTHER CONSOLIDATION IN THE U.S. AIRLINE INDUSTRY WILL HAVE ADVERSE ECONOMIC EFFECTS ON CITIES THAT HAD ONCE ENJOYED THE BENEFITS OF INDUSTRY GROWTH. FOR EXAMPLE, HUB AIRPORTS, SUCH AS ST. LOUIS, CURRENTLY ENJOY LEVELS OF SERVICE THAT WOULD BE LOST IF TWA CEASED OPERATIONS. WE ARE HOPEFUL THAT THE NEW ADMINISTRATION WILL NOT BE SO WILLING TO TRANSFER ROUTES AND SLOTS, APPROVE MERGERS AND NEGLECT THE EFFECT EACH TRANSACTION HAS ON THE WORKERS.

SOMEWHAT PREDICTABLY, AIRLINE EXECUTIVES STILL BLAME LABOR FOR MOST OF THEIR FINANCIAL DIFFICULTIES DURING THE '80s AND '90s. THIS DESPITE THE FACT THAT FLIGHT ATTENDANTS COSTS, FOR EXAMPLE REPRESENT ONLY FOUR TO SIX PERCENT OF U.S. AIRLINE'S TOTAL OPERATING COSTS. DOMESTIC FLIGHT ATTENDANTS' STARTING PAY AVERAGES ONLY ABOUT \$12,850 PER YEAR -- COMPARABLE TO ONLY \$6.17 PER HOUR FOR SOMEONE WORKING A STANDARD 40 HOUR WEEK. IT TAKES 12 TO 14 YEARS BEFORE FLIGHT ATTENDANTS CAN EXPECT TO REACH THE TOP OF THE LONGEVITY SCALE AND DOUBLE THEIR EARNINGS.

WHILE MANAGEMENT BLAMES LABOR FOR ITS PROBLEMS, LABOR CAN, MORE ACCURATELY, BLAME MANAGEMENT AND THE GOVERNMENT. DEREGULATION AND POOR MANAGEMENT ARE WHAT BROUGHT THE INDUSTRY TO ITS CURRENT

STATE. SOME PEOPLE SEEM TO BE SURPRISED BY THE FRUITS OF DEREGULATION. LABOR IS NOT SURPRISED. WE PREDICTED IT ALL ALONG.

CAN IT GET WORSE? YES, AND THINGS WILL CONTINUE TO WORSEN WITH THE FUTURE INCLUDING A GLOBAL MARKET, INCREASE FOREIGN CONTROL, AND POSSIBLY CABOTAGE. AS GLOBAL COMPETITION INCREASES AND THE SHAKE DOWN IN THE DOMESTIC AVIATION SECTOR CONTINUES, PRESSURES WILL MOUNT TO INCREASE FOREIGN CONTROL OF U.S. FLAG CARRIERS AND TO PERMIT CABOTAGE. WE CANNOT ALLOW FOREIGN FLAG CARRIERS TO HAVE A COMPETITIVE ADVANTAGE BY LIBERALIZING LANDING RIGHTS, PERMITTING CABOTAGE, OR TAKING OTHER STEPS UNLESS THERE IS ABSOLUTE RECIPROCITY. TO DO SO WOULD BE TO GIVE AWAY U.S. JOBS. SIMILARLY, EFFORTS TO INCREASE FOREIGN CONTROL OF U.S. FLAG CARRIERS SHOULD BE EXAMINED TO INSURE THAT U.S. RETAINS A VITAL AVIATION SECTOR. EACH TRANSACTION INVOLVING FOREIGN INVESTMENT IN U.S. CARRIERS MUST BE CAREFULLY REVIEWED TO INSURE THAT U.S. CONSUMERS AND WORKERS RECEIVE SUFFICIENT BENEFIT IN RELATION TO THE INVESTMENT.

CABOTAGE WOULD OPEN A WHOLE NEW REALM OF DOWNWARD PRESSURE ON U.S. JOBS AND WAGES. AS WE HAVE SEEN IN OTHER INDUSTRIES, CHANGING U.S. LAW AND POLICY TO PERMIT UNRESTRICTED ACCESS TO THE U.S. MARKET WOULD DO LITTLE MORE THAN EXPORT JOBS AND IMPORT POVERTY. LABOR IS PREPARED TO FIGHT TO PREVENT THAT FROM HAPPENING BECAUSE, AS WE HAVE SEEN, ANY FUNDAMENTAL CHANGE IN THE

INDUSTRY CAN DEEPLY AFFECT THE WORKERS. AS THE GOVERNMENT MAKES CHANGES IN POLICY OR AS CONGRESS LEGISLATES CHANGE, YOU MUST THINK OF THE EFFECTS THESE CHANGES HAVE, NOT ONLY ON THE INDUSTRY, BUT SPECIFICALLY ON THE WORKERS IN THE AIRLINE INDUSTRY. REMEMBERING THE AIRLINE WORKERS IS ESSENTIAL TO THE SURVIVAL OF THE INDUSTRY.

WE STRONGLY BELIEVE THAT THE FEDERAL GOVERNMENT SHOULD TAKE LEGISLATIVE AND ADMINISTRATIVE ACTION TO HELP THE AIRLINE INDUSTRY. BUT, INCREASING FOREIGN CONTROL AND CABOTAGE ARE NOT THE ANSWERS. AT THE SAME TIME, AVIATION WORKERS NEED TO BE ON A LEVEL PLAYING FIELD WITH THEIR EMPLOYERS. WE URGE YOU TO START BY PROTECTING THE WORKERS. IT IS VITALLY IMPORTANT THAT LABOR PROTECTIVE PROVISIONS BE GRANTED DURING MERGERS. THIS WILL PROTECT WORKERS FROM BEING LAID OFF WITHOUT SOME TYPE OF COMPENSATION AND PROVIDE FOR A FAIR PROCESS FOR COMBINING WORKFORCES.

WE ALSO BELIEVE THERE SHOULD BE MORE VIGILANCE ON THE PART OF THE GOVERNMENT IN ENFORCING ANTI-TRUST LAWS TO PREVENT FURTHER CONSOLIDATION AND CONCENTRATION IN THE AIRLINE INDUSTRY. THIS WILL ENSURE THAT THE REMAINING COMPETITION STAYS INTACT. ALSO, IT WILL ENCOURAGE NEW ENTRANTS, THUS PROVIDING PASSENGERS WITH MORE CHOICES AND REASONABLE FARES, AND PROVIDING FLIGHT ATTENDANTS AND OTHER AIRLINE WORKERS WITH JOBS AND SOME STABILITY. THESE CHANGES WILL NOT ONLY BENEFIT THE WORKERS BUT

WILL GREATLY PROTECT AND AID CONSUMERS. WE MUST REMEMBER THAT CONSUMERS ALSO HAVE BEEN DEEPLY AFFECTED BY THE STATE OF THE AIRLINE INDUSTRY. A 1992 STUDY BY THE GENERAL ACCOUNTING OFFICE REVEALS THAT PRICING AT CONCENTRATED AIRPORTS (HUBS) IS 21% HIGHER THAN AT COMPETITIVE AIRPORTS.

IN CONCLUSION, IT IS IMPERATIVE THAT WE SAVE THE AIRLINE INDUSTRY BUT NOT AT THE EXPENSE OF AIRLINE WORKERS. FLIGHT ATTENDANTS AND OTHER AIRLINE WORKERS HAVE ALREADY LOST THEIR JOBS, THEY HAVE BEEN RELOCATED, THEY HAVE BEEN FORCED TO TAKE CONCESSIONS...AND STILL THE INDUSTRY IS NO HEALTHIER. IT IS TIME TO TAKE ACTION AND LOOK AT WAYS TO BETTER MANAGE COMPANIES AND RUN THE INDUSTRY. LET US NOT RUSH INTO FOREIGN CONTROL AND CABOTAGE IN HOPES THAT IT WILL BECOME THE INDUSTRY'S CURE. WE ARE HERE TODAY TO SAY IT WILL NOT HELP THE U.S. AIRLINE INDUSTRY. IT COULD IN FACT DESTROY THE INDUSTRY AND THE LIVELIHOOD OF TENS OF THOUSANDS OF AIRLINE WORKERS. WE URGE YOU TO HEED THESE EARLY WARNINGS AND LOOK OUT FOR THE WORKERS AND THE TRAVELLERS THEY SERVE.

MEMBERS OF THE SUBCOMMITTEE, THANK YOU AGAIN FOR ALLOWING ME TO TESTIFY TODAY BEFORE YOU TO DISCUSS THE AIRLINE INDUSTRY AND THE ADEQUACY OF COMPETITION FROM THE FLIGHT ATTENDANT PERSPECTIVE. WE MUST WORK NOT ONLY TO ENSURE THE SURVIVAL OF THE AIRLINE INDUSTRY, BUT ALSO TO PROTECT THE WORKERS - ITS MOST VITAL COMPONENT. I WILL BE PLEASED TO ANSWER ANY QUESTIONS.

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United States General Accounting Office

GAO

Testimony

Before the Subcommittee on Economic and Commercial Law,  
Committee on the Judiciary, House of Representatives

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## AIRLINE COMPETITION

### Industry Competitive and Financial Issues

Statement for the Record of  
Kenneth M. Mead, Director, Transportation Issues  
Resources, Community, and Economic Development Division



Mr. Chairman:

Over the past several years, GAO has completed an extensive body of work on the airline industry. We have recently testified on our work before the House Committee on Public Works and Transportation, Subcommittee on Aviation. Our statement summarizes that work and draws from it to offer our observations on the directions the Congress and the new administration might pursue to protect the interests of the traveling public while simultaneously ensuring a financially healthy competitive airline industry. A bibliography of GAO reports and testimonies on the industry's financial and competition problems is included (see app. V).

Our basic points are the following:

-- The Airline Deregulation Act of 1978 phased out economic regulation of the airline industry. The industry was deregulated because it was widely believed that the industry was naturally competitive and that there were few economies of scale. Experience at that time with deregulated intrastate air travel markets in California and Texas supported the view that lower fares and more competition would result from deregulation. In the years immediately following deregulation many new airlines entered the industry, existing carriers expanded operations, competition flourished, and fares fell. By the mid-1980's, however, the industry began to reconcentrate as a wave of mergers and bankruptcies swept over the industry. While entering the airline industry was relatively easy, successfully overcoming the advantages of the larger incumbent airlines proved more difficult. By some measures the airline industry today is as concentrated as it was before deregulation. Nevertheless, while there are some airports where fares are higher than elsewhere because one or two airlines dominate the traffic, airline

fares, on balance, continue to be lower than before deregulation, after adjusting for inflation.

- Nearly all the major U.S. airlines have sustained serious losses over the last 3 years, but these losses have been especially severe for the financially weakest airlines. The five major airlines that have failed or have been operating in bankruptcy have seen their market share fall from about 35 percent in 1987 to less than 18 percent in 1992. At the same time, the three largest airlines have increased their market share from 41 percent to almost 58 percent.<sup>1</sup>
- No single factor can explain all of the airlines' financial problems. High debt-service costs resulting from leveraged buy-outs, ill-timed expansions, excess capacity, limited access to capital,<sup>2</sup> and fare wars have all contributed to the losses. The recession has exacerbated the industry's financial condition. There have also been allegations, although unsubstantiated, that bankrupt airlines have sometimes charged fares that did not cover their costs of operations, thereby exacerbating industry losses as competing airlines matched the below cost fares. Aggressive fare strategies are not limited to bankrupt airlines and we urge caution in addressing pricing issues. In addition, physical and marketing barriers to competition, such as restricted access to key airports and

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<sup>1</sup>The five airlines are Eastern and Pan Am (which ceased operations in 1991); America West and TWA (which are reorganizing under bankruptcy court protection); and Continental (which recently emerged from bankruptcy). The three largest airlines are American, United, and Delta. Market shares are based on systemwide revenue passenger miles.

<sup>2</sup>A major limitation on U.S. airlines' access to capital is the restriction on foreign investment and control.

computerized reservation systems (CRS), have made it difficult for the smaller and financially weaker airlines to compete, especially in markets dominated by the largest airlines.

-- Just as no single factor explains the current state of the industry, no single action will address its interrelated financial and competitive problems. Thus, the challenge will be for the Congress and the new administration to work with the industry toward a broad and well-designed strategy that combines efforts to reduce entry barriers with efforts to ensure financial stability. The National Commission to Promote a Strong and Competitive Airline Industry would be one possible vehicle for developing such a strategy. In our opinion, such a strategy would be most effective if it contained four key elements: (1) improving U.S. airlines' access to capital markets through relaxing the restrictions on foreign investment and control, under certain conditions; (2) enhancing access to the growing international market for all U.S. airlines; (3) reducing barriers to competition; and (4) examining the claims and counterclaims about airline pricing practices, especially those of bankrupt airlines.

#### THE AIRLINE INDUSTRY'S EXPERIENCE WITH DEREGULATION

Economic regulation of the airline industry was phased out by the Airline Deregulation Act of 1978. It was widely believed that the industry did not exhibit the characteristics of an industry that needed economic regulation. There did not appear to be any significant barriers to industry or market entry, nor did there appear to be substantial economies of scale that would limit the number of efficient and profitable firms. Moreover, experience with deregulation in intrastate markets in Texas and California indicated that deregulation could succeed in lowering fares.

Numerous studies of the industry concluded that regulation had led to excessive costs, high fares, and service levels that differed from what the market would yield.

In the years immediately following deregulation, many new firms entered the industry, fares fell, and competition flourished. Airline fares, in real terms, had been falling for many years, but in the period prior to deregulation, the decline traced to technological improvements such as the introduction of jets or wide body aircraft. The drop in fares following deregulation was not associated with any dramatic technological improvement and was, instead, due to increased competition.

However, in the mid-1980's the airline industry experienced a wave of mergers and bankruptcies that caused the industry to begin to reconcentrate. GAO examined the Department of Transportation's (DOT) performance in reviewing the mergers and concluded that DOT had not adequately taken into account the impacts on competition when it reviewed mergers.<sup>3</sup> In another study we examined the changes in airline fares and services at St. Louis following the merger between TWA and Ozark Air Lines.<sup>4</sup> We found that fares increased substantially following the merger, especially on routes where TWA and Ozark had been competitors. This study led to a broader review of airline fares at airports where one or two airlines handle most of the traffic and we found that fares were more than 20 percent higher at concentrated airports.

In addition to GAO's examination of airline fares at specific airports, we also analyzed alleged anticompetitive practices and

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<sup>3</sup>Airline Competition: DOT's Implementation of Airline Regulatory Authority (GAO/RCED-89-93, June 28, 1989).

<sup>4</sup>Airline Competition: Fare and Service Changes at St. Louis Since the TWA-Ozark Merger (GAO/RCED-88-217BR, Sept. 21, 1988).

conditions that could lead to higher fares. Specifically, we reviewed allegations about excessive profits being earned by the computerized reservations systems (CRS) by the two largest airlines. While data limitations made it difficult to conclude that the CRS-owning airlines were earning excess profits, on the basis of subsequent data collected by DOT, it became clear that substantial revenues were being transferred to the major CRS-owning airlines.<sup>5</sup> We undertook a broader review of the so-called barriers-to-entry in the airline industry, including CRSs and identified both physical and marketing barriers-to-entry. Physical barriers include restricted access to gates and other key facilities at the nation's major airports and the inability to obtain landing and take-off rights at key slot-controlled airports. Based on an extensive survey of airport officials, we determined that most of the gates and other key facilities were controlled by the incumbent airlines under long-term, exclusive use leases making it more costly for new entrants to secure airport access. In addition, we found that the market for slots established by DOT was not effective in improving access to the key slot-controlled airports.<sup>6</sup>

In addition to physical barriers to entry, we also examined airline marketing practices such as frequent flyer programs, code sharing arrangements and travel agent commission overrides that also can be barriers to entry. Our survey of 500 travel agents revealed that these marketing practices influenced their clients' preferences and the agents' booking patterns. We modeled the impact of some of the physical and marketing barriers to entry on

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<sup>5</sup>Competition in the Airline Computerized Reservation System Industry (GA/T-RCED-88-62, Sept. 14, 1988).

<sup>6</sup>Airline Competition: Industry Operating and Marketing Practices Limit Market Entry (GAO/RCED-90-147, Aug. 29, 1990).

airline fares.<sup>7</sup> Our econometric analysis revealed that while each of the barriers in our model had a statistically significant impact on airline fares, no single factor greatly dominated the rest.<sup>8</sup> This implies that any policy designed to address anticompetitive problems must be comprehensive. GAO has supported attempts to improve competitive access. For example, we supported removing the restrictions on passenger facility charges to give airports a source of revenue for expansion that did not depend on incumbent airlines.

Our studies have shown that while airline passengers continue to benefit from lower fares, the industry is becoming more concentrated. If this reconcentration results in market dominance, then fares could eventually rise above competitive levels and some of the principal benefits of deregulation could be lost. Although nearly all the domestic U.S. airlines have suffered losses over the past several years, the airlines that have been most successful in gaining competitive advantages through the erecting of entry barriers have fared better in the competitive struggle.

#### THE INDUSTRY'S CURRENT FINANCIAL PROBLEMS MAY REDUCE FUTURE COMPETITION

The major U.S. airlines have lost over \$10 billion in the last 3 years. (See app. I, table I.1.) However, that aggregate figure is skewed by the huge losses suffered by a few airlines. For example, about two-thirds of the industry's 1990 and 1991 losses were recorded by Eastern, Pan Am, and Continental. Among the airlines reporting full-year financial results for 1992, about half of the losses reported are due to the new Financial Accounting

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<sup>7</sup>We were able to model most of the entry barriers, but for some, including frequent flyer plans, adequate data were not available.

<sup>8</sup>Airline Competition: Effects of Airline Market Concentration and Barriers-to-Entry on Airfares (GAO/RCED-91-10-1, Apr. 26, 1991).

Standard (FAS 106), which changes the way retiree medical and life insurance benefit costs are recorded. (See app. I, table 1.2) In addition, some of the losses reported by the three largest and strongest airlines (American, Delta, and United) stem from the costs associated with integrating the assets they have purchased from their bankrupt rivals in the last few years. For example, Delta's 1992 operating expenses rose more than 20 percent from calendar year 1991, largely because of the costs associated with the takeover of Pan Am's European operations.

In response to their losses, the major airlines have been implementing cost-cutting programs, laying off employees, cancelling or delaying aircraft deliveries, and refocusing service. For example, TWA reduced overall capacity by almost 20 percent between 1990 and 1992, and USAir closed its Dayton, Ohio, hub. While such actions should help the industry improve its financial performance, they can have negative impacts on an airline's long-term competitive position. For example, cancelling or delaying aircraft deliveries can reduce current capital spending but can also limit future service options because of airport noise reduction programs that restrict the use of older, noisier aircraft.

#### Financial Problems Weaken Competition and Reduce Profitability

Both GAO and the Department of Transportation (DOT) have found that consumers pay higher fares when flying from airports where there is little competition. In our analysis of 1988 fares,<sup>9</sup> we found that fares for flights from concentrated airports were about 20 percent higher than for trips of similar lengths from other

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<sup>9</sup>Airline Competition: Higher Fares and Reduced Competition at Concentrated Airports (GAO/RCED-90-102, July 11, 1990). Our study compared fares on the basis of yield, i.e., fare per passenger mile.

airports.<sup>10</sup> We are updating this study and the results should be available early this summer. DOT reported that fares at a group of eight airports dominated by one airline were about 19 percent higher than average fares in 1988.<sup>11</sup> A recently released DOT study of 1991 fares showed no change in this premium. While most routes continue to be served by several competitors, if the industry continues to consolidate, the decrease in competition could lead to higher fares.

Since January 1990 two major airlines have ceased operations and three more have been reorganizing under bankruptcy court protection. The financially weaker airlines have also sold more than \$2 billion worth of assets, primarily international route rights and slots,<sup>12</sup> to their stronger competitors. (See app. II.) The market shares of the five bankrupt major airlines have fallen from 35 percent in 1987 to less than 18 percent in 1992. During that same period, the market share of the three largest airlines has grown from about 41 percent to almost 58 percent.

Over the past decade, several large airlines have developed serious problems that weaken their financial positions. Chief among these problems are the high levels of debt some airlines have incurred to finance leveraged buy-outs and expansion plans and the operating and marketing practices that raise the costs of competing with the dominant airlines in a market. The five major airlines in

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<sup>10</sup>We classified an airport as concentrated if one airline handled at least 60 percent of the passengers enplaning at that airport, or two airlines handled at least 85 percent of the enplaning passengers. We excluded airports in metropolitan areas served by more than one commercial airport, such as New York City and Chicago, and airports outside the contiguous 48 states.

<sup>11</sup>In the DOT study, airports were classified as concentrated if one airline enplaned 75 percent or more of the passengers.

<sup>12</sup>A slot is a reservation for take-off or landing at one of four U.S. airports where access is restricted under the High Density Rule (14 C.F.R. Part 93, Subpart K).

financial trouble in 1990--America West, Continental, Eastern, Pan Am, and TWA--all experienced substantial increases in their debt ratios (i.e., long-term debt as a percentage of total capitalization) during the 1980s. All of those airlines had average debt ratios over 80 percent. In contrast, the other six major airlines all held their debt ratios under 65 percent, and most of them held their average debt ratios under 50 percent in 1985-89. (See app. IV.)

In the future, airlines will have to spend billions of dollars to repair and modify older aircraft to ensure safety and reduce noise. For example, we have estimated the industry's cost of retrofitting or replacing noisier Stage 2 aircraft to be between \$2 billion and \$5 billion dollars.<sup>13</sup> In addition, airlines must finance the acquisition of new aircraft if they are to remain competitive.

Many factors affect the profitability of the airline industry and of individual airlines. Demand for air travel is sensitive to swings in the level of economic activity and to unexpected events, such as the increased concern about air travel safety during the Persian Gulf War.

For more than a decade, profit margins in the U.S. airline industry have been about half those of the average U.S. company in other industries, and airlines have had to borrow or sell stock to raise capital. Debt financing, whether through issuing debt instruments such as bonds or through the sale-leaseback of aircraft, carries fixed charges for interest, principal, and lease payments. In a cyclical industry like the airline industry, revenues available to cover fixed charges may fluctuate widely,

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<sup>13</sup>Aviation Noise: Costs of Phasing Out Noisy Aircraft (GAO/RCED-91-128, July 2, 1991), p. 2. Our estimate reflects the present-value cost to the industry in 1990 dollars.

making it difficult to cover fixed charges during cyclical downturns in demand or short-term increases in costs. Another way to raise additional capital is to sell stock. However, because of their low returns, the weaker U.S. airlines are not likely to attract much additional equity investment from U.S. sources. Therefore, the most likely investors are foreign airlines that believe they can capitalize on operating synergies between the two airlines, something nonairline investors cannot do.

Some industry observers believe that the actions of certain bankrupt airlines may have also affected profitability. Because bankrupt firms can suspend repayment of long-term debt, they may set prices to generate sufficient cash flow to meet short-term needs, rather than setting prices that cover the full costs of operation.<sup>14</sup> To remain competitive, the other airlines would have to respond by matching these low fares and, as a result, suffer losses.

However, it is true that the airline industry has often experienced excess capacity during economic downturns. Because the airline product--a seat-mile of service--cannot be stored, but is instead lost as soon as the plane takes off, the airlines are under pressure to fill their seats, as long as the fare covers the marginal cost of providing the seat. This behavior can also lead to fares below full cost, which can erode industry profit margins.

#### STRATEGIES FOR ADDRESSING AIRLINE FINANCIAL AND COMPETITIVE PROBLEMS

We believe that the most appropriate approach to resolving the competitive and financial problems of the airline industry is to focus on strategies that address the multiple factors that have led

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<sup>14</sup>The full costs of operation would include, for example, the costs of financing aircraft.

to the current problems. Airlines' access to capital needs to be improved, possibly by relaxing restrictions on foreign investment and control. However, improved access to capital is not a panacea for the airlines' financial and competitive problems. Access to international markets also needs to be enhanced, and the relaxation of U.S. restrictions on foreign investment could be linked to gaining better access for U.S. airlines to international markets. In addition, a number of barriers to competition resulting from airline marketing and operating practices continue and must be reduced if competition is to thrive. Finally, claims about unfair pricing practices need to be carefully examined before any action is taken to "protect" the airlines.

#### Improving Airlines' Access to Capital

U.S. airlines have not generated an attractive rate of return in recent years and, as a result, must either sell equity or borrow or to finance capital needs. However, borrowing raises fixed costs for debt repayment and many airlines already have heavy debt loads. Moreover, because of low rates of return, the most likely investors in the financially weaker U.S. airlines are other airlines that can capitalize on operating and marketing synergies. The continuing consolidation within the U.S. airline industry may mean that further mergers between U.S. airlines could have a difficult time clearing the Justice Department's antitrust scrutiny. The most likely investors, therefore, are foreign airlines that could link the domestic and international operations of the U.S. airline with their own route systems. For example, DOT recently approved Air Canada's investment in Continental, and USAir and British Airways have announced a modified version of their previous investment agreement, which was withdrawn last December.

We have examined the issue of foreign investment in some detail.<sup>15</sup> Federal law currently limits foreign investment in U.S. airlines to 25 percent of the airline's voting stock. In addition, the president and two-thirds of the airline's board of directors, and key management officials must be U.S. citizens. DOT interprets the law to require that effective control must also remain in the hands of U.S. citizens. Some of the reasons that the restrictions were first put in place, such as protection of a heavily subsidized, fledgling industry, are no longer a concern. Allowing greater foreign investment could help some U.S. airlines remain viable competitors, thus enhancing domestic competition. However, other concerns remain.

On the one hand, foreign airlines are not likely to invest substantially in U.S. airlines, particularly the weaker ones, unless they can (1) exercise control over their investment commensurate with the amount of voting stock held and (2) integrate the operations of the two airlines into one system. On the other hand, U.S. airlines that already have significant international operations are concerned that allowing a foreign airline to gain control over a U.S. airline could place them at a competitive disadvantage, especially if the investing foreign airline is from a country that has a particularly restrictive bilateral agreement.

There are other issues in the debate on foreign investment and control as well. The Department of Defense is concerned about the continued availability of commercial aircraft and crews to supplement its own airlift capacity in times of military emergency. Airline labor unions are concerned about potential job losses, especially high-paying crew jobs on international flights, if foreign airlines are allowed to gain effective control over U.S. airlines.

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<sup>15</sup>Airline Competition: Impact of Changing Foreign Investment and Control Limits on U.S. Airlines (GAO/RCED-93-7, Dec. 9, 1992).

Our analysis of the likely impacts of changing foreign investment and control limits showed that these interests and concerns could be addressed. If the Congress chooses to relax the limits on foreign investment and control of U.S. airlines, DOT could be required to proactively consider potential impacts on international aviation competition in assessing the proposed investment, and eligibility to make such investments could be limited to airlines from nations that are willing to exchange improved access to their markets. The Congress could also expand DOT's review of these transactions to consider their potential impact on national security. We also suggested that our examination of potential job impacts concluded that there are practical limits to the number of jobs that might be lost and that U.S. airline employees are highly cost-competitive with their international counterparts. Finally, the potential for jobs to be lost if an airline ceases operations because it cannot get the capital needed to stay afloat is likely to be much greater than any losses associated with increased foreign investment and control.

Domestic Issues Should Be Considered  
in the Context of the Changing  
International Environment

The second element of the strategy is enhancing access to international markets. The international aviation industry, like the domestic industry, has been changing. The international market is expected to grow about twice as fast as the domestic market through the year 2000. Thus, the major U.S. airlines have begun to focus greater attention on expanding their international operations. Between 1987 and 1991 the proportion of major U.S. airlines' systemwide revenue passenger miles represented by international operations grew about 22 percent, and international operations now account for about 26 percent operations. (See app. III.) For the three largest major airlines, the growth in

international operations has been dramatic, with international revenue passenger miles more than doubling between 1987 and 1991.

Access to international markets is regulated by bilateral agreements between governments that set the conditions under which U.S. and foreign airlines operate and compete. These agreements, known as bilaterals, can restrict competition by limiting the services and fares that can be offered. The United States has 72 bilaterals with 95 countries around the world, each one separately negotiated. Although the European Community (EC) has integrated its internal market, the European Commission does not yet negotiate aviation issues for the 12 EC member nations as a whole. While the United States can mandate change in the domestic industry, it can influence, but cannot dictate, the pace of international change. Change in the international arena is likely to be slow because of the many bilaterals in place and the necessity of negotiating changes with each country individually under the current system. We believe that an examination of U.S. policy, to ensure that it encourages greater international competition, protects the interests of consumers, and allows all U.S. airlines to participate in international markets, would be useful.

Also, while some industry analysts believe that the system of bilaterals will be replaced by a more open, competition-oriented system, the results of recent negotiations with our aviation trading partners are mixed. For example, within the past year the United States had concluded an open-skies bilateral with the Netherlands, but several other countries--France, Germany, and Japan--have requested changes to their bilaterals, such as temporary capacity constraints, that would place additional limits on competition. In addition, many industry officials and analysts believe that the current consolidation in the U.S. airline industry is the precursor of a global trend, leading to the eventual domination of worldwide aviation by a handful of mega-carriers. Thus, many U.S. and foreign airlines have been developing networks

of equity and marketing alliances to improve access to each others' international and domestic markets and thereby improve their chances of surviving the expected restructuring.

An airline's financial condition affects whether it can continue to participate in international markets and how it can participate. The financially distressed airlines have sold international routes, and some have reduced their participation in the international market, while the stronger U.S. airlines have expanded their international operations. In addition, some of the smaller or financially weaker U.S. airlines have had to rely on marketing agreements with foreign airlines to continue or expand their participation in some international markets. Thus, U.S. airlines must be financially sound if they are to continue to play a significant role in international markets.

#### Barriers to Competition Limit Market Entry and Raise Fares

In the past several months a number of new, start-up airlines have begun service and their success could bode well for the future of competition in the industry. Therefore, the third element of the strategy is addressing the barriers to market entry on which we have reported and testified extensively. Airline operating and marketing practices make it more difficult for some airlines to compete by limiting access to airports and by limiting the ability of new airlines on a route to market their services. These practices also affect airline profitability by raising costs of competing airlines. When entry into markets is constrained, competition is reduced. In our 1991 report,<sup>16</sup> we found that fares were 5 to 9 percent higher on routes when two or more of these barriers were present. We have previously presented a number of

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<sup>16</sup>Airline Competition: Effects of Airline Market Concentration and Barriers to Entry on Airfares (GAO/RCED-91-101, Apr. 26, 1991).

options for addressing these barriers, which we will summarize today.

#### Certain Practices Limit Access to Airports

Airport access is limited by the practice of leasing airport gates and other facilities to airlines on long-term, exclusive-use leases. These leases give control of key airport facilities to airlines and make it possible for them to exclude other airlines from using the facilities. Federal government action to encourage the use of preferential-use leases on airport facilities could help improve access to the terminal facilities an airline needs to offer service.<sup>17</sup> Since new facilities built with Passenger Facility Charges (PFC) cannot be leased on long-term, exclusive-use leases, the 1990 PFC legislation clearly moved in that direction.<sup>18</sup> As of November 1992, this legislation has made more than \$75 million available for terminal expansion projects that could increase competition.

Another factor limiting airport access is the FAA's High Density Rule, which restricts access to take-off and landing slots at four key airports--Washington's National, Chicago's O'Hare, and New York's Kennedy and La Guardia Airports. Competition at the slot-controlled airports could be enhanced if slots were made available to airlines with little or no service at those airports. The limits on operations at the slot-controlled airports were designed to tailor demand for air traffic services to the capacity of the airports. However, technical improvements in air traffic control may make it feasible for FAA to increase the number of

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<sup>17</sup>A preferential-use lease protects the primary lessee's right to use the facilities whenever the airline has operations scheduled, but allows the airport to make the facilities available to other airlines when the facilities would otherwise be idle.

<sup>18</sup>PFCs were authorized in 49 U.S.C. app. sec. 1513(e).

slots available at those airports. In addition, the buy/sell rule, which was designed to create a market in slots, could be altered to encourage airlines to sell slots they do not use.

Marketing Practices Limit the Ability of Airlines Entering New Markets to Compete

Certain airline marketing practices also limit competition. These practices include computerized reservation systems (CRS), travel agent incentives, frequent flyer plans, and code-sharing.

CRSs and Travel Agent Incentives--Because each airline must, as a practical matter, have its flights listed on each CRS in order to market its flights successfully, each airline must pay the booking fees charged by the other airlines that own the CRSs. As we reported in 1991,<sup>19</sup> the lack of effective competition in the CRS industry allows the dominant CRSs, which are controlled by American and United, to each receive substantial revenues, in excess of the costs of the service provided (including a reasonable profit),<sup>20</sup> from other airlines in the industry, most of which are financially weaker. Travel agent commission overrides may also restrict competition.<sup>21</sup> Commission overrides and other travel agent incentives encourage agents to divert traffic to the airline offering the best incentives, usually the largest in the market, when the passenger's needs can be met by the services of more than one airline.

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<sup>19</sup>Airline Competition: Weak Financial Structure Threatens Competition (GAO/RCED-91-110, Apr. 15, 1991).

<sup>20</sup>Based on data collected by DOT for its 1988 study of the CRS industry, we calculated that the two dominant CRSs annually transferred over \$300 million to their airline owners. Although we recommended that DOT update its information on the CRS industry, DOT has not gathered more recent data.

<sup>21</sup>Commission overrides are bonus commissions paid by individual airlines to travel agents to encourage booking on a particular airline.

DOT issued new CRS rules in September 1992 that addressed the concerns we have raised in the past about the contractual relationships between travel agents and CRS vendors. These concerns included minimum-use clauses, automatic rollovers, and 5-year minimum contract terms. The new regulations should make it easier for travel agents to change systems. However, DOT did not address the problem of booking fees. Eliminating or reducing booking fees would halt or reduce the revenue transfers from participating airlines to CRS vendor airlines. Although such a strategy could raise the cost of the systems for travel agents, travel agents are in a better position to negotiate terms with the vendors than are the airlines that, as a practical matter, must participate in every system. Alternatively, requiring arbitration of increases in booking fees could give participating airlines some leverage and help minimize revenue transfers. In addition, eliminating commission overrides and other travel agent incentives could reduce agents' tendency to book on the dominant airline in a market. However, policies to eliminate the adverse effects of CRSs on competition should be designed to preserve their positive features. Consumers benefit from CRSs because the systems allow travel agents to quickly search among the fare, route, and schedule offerings of competing airlines to find the flight that best meets the passenger's needs.

Frequent Flyer Plans--Frequent flyer plans may also have a significant effect in reinforcing the market power of dominant airlines. Our survey of travel agents indicated that business flyers often choose an airline on the basis of frequent flyer plans, which generally favor the larger airlines in each market. The aspects of frequent flyer plans that reinforce the market power of dominant airlines could be reduced without eliminating the plans. For example, making mileage transferable between passengers belonging to the same plans would reduce passengers' incentives to fly only with the dominant airline in a market, but airlines and travelers would still benefit from the plans. Benefits would occur

because passengers must still take flights on an airline to earn awards from that airline, but the passengers do not have to concentrate their travel on a single airline if they can trade mileage earned with other travelers who belong to the same frequent flyer programs.

Code-sharing Agreements--Code-sharing agreements<sup>22</sup> appear to strengthen the position of major airlines with such agreements, especially at the airlines' hubs. One option for reducing the anticompetitive impact of code-sharing would be to remove the preference code-shared flights currently have over interline flights in CRS displays,<sup>23</sup> since flights that are displayed sooner are more likely to be booked. However, our survey of travel agents showed that passengers tend to prefer code-shared flights over interline flights because of customer convenience factors, such as the proximity of gates for changing planes and increased reliability in baggage handling. Thus, passengers should at least have information on whether code-shared flights are available so that they may choose the service that best meets their needs.

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<sup>22</sup>Code-sharing agreements are cooperative marketing agreements, generally between large airlines and smaller, commuter airlines, in which the commuter airline transports connecting passengers to and from the larger airline's flights. The passenger's ticket shows the two-letter airline code of the larger airline for all segments of the trip even though part of the trip is actually flown on the smaller airline.

<sup>23</sup>Interlining arrangements are the traditional method by which airlines facilitate travel for passengers who must use more than one airline to reach their destinations. Interlining agreements between airlines allow the passenger to book passage on one airline for the first part of a trip, on a second airline for the second part of a trip, and on other airlines for subsequent parts of the trip.

Conflicting Claims About Airline Pricing  
Practices Should Be Carefully Examined

The fourth element of the strategy is a careful examination of the claims and counterclaims about the role of airline pricing practices in the industry's financial difficulties. We urge caution before acting on the claims and counterclaims about the pricing practices of airlines. The extent of the problem and its systemwide effects need to be established and weighed against the longer-term competitive implications of any proposed action. Some industry observers believe that bankrupt airlines may be pricing below the full costs of operations. However, because the bankruptcy code is not structured on an industry-specific basis, any action to change the bankruptcy laws would likely affect firms in other industries as well as airlines. In addition, actions that would force airlines to limit time spent in reorganization could force additional airlines to simply cease operations and adversely affect the interests of airline creditors. If measures were implemented to protect the non bankrupt airlines from alleged below-cost pricing by bankrupt airlines, these measures could make it more difficult for bankrupt airlines to successfully reorganize, regain financial health, and offer effective competition. Moreover, not all discounting is initiated by bankrupt airlines. Finally, actions to limit airline pricing activity could harm consumers by reintroducing fare regulation and raising fares.

Thus, there are risks to competition from intervening in the market, even if there is a need to protect airlines from unfair pricing practices, whether the practices emanate from bankrupt airlines or from other airlines. In our opinion it is crucial to first determine whether the pricing practices of the airline industry are unique and would thus warrant different treatment before giving consideration to changing airline pricing behavior or to changing the bankruptcy laws.

CONCLUSIONS

Overall, deregulation of the domestic airline industry has benefited U.S. consumers and has made U.S. airlines more efficient competitors. Fares are lower and service is more frequent on many routes. U.S. airlines have become more efficient, and U.S. airline employees are among the world's most productive. Nevertheless, some firms in the industry face serious financial problems, and the long-term competitive health of the industry could be at risk. In selecting solutions to the more systemic problems facing the industry, such as barriers to entry and access to capital, a well-designed, broad strategy that covers the elements we have outlined today is the best approach for improving the long-term financial status of distressed airlines and making them more effective competitors. Postponing action will dramatically narrow the range of options open to the Congress. Ensuring a competitive market will be much more difficult with fewer airlines in the marketplace.

## Appendix I

## Appendix I

Table I.1: YEARLY AND CUMULATIVE NET INCOME/LOSSES OF MAJOR U.S. AIRLINES, 1987-92

Airline	1987	1988	1989	1990	1991	1992	1987-92 total
America West	\$ (45.7)	59.4	820.0	\$ (78.7)	\$ (213.0)	(131.0)	(430.0)
American	207.8	469.5	423.1	(70.0)	(239.0)	(935.0)	(171.0)
Continental	(258.0)	(213.3)	3.1	(1,238.0)	(309.7)	(129.3)	(2,237.0)
Delta	217.3	386.3	473.2	(156.0)	(239.3)	(564.0)	76.0
Eastern	(181.7)	(335.6)	(692.3)	(1,113.9)	b	b	(2,685.3)
Northwest	140.7	102.6	355.2	(10.0)	(3.1)	(303.0)	161.4
Pan Am	(274.8)	(116.3)	(616.7)	(630.1)	(203.1)	0	(1,730.0)
Southwest	1.0	57.4	71.4	47.1	36.9	102.0	310.2
TWA	106.2	269.7	(290.8)	(237.6)	68.2 <sup>d</sup>	(239.0)	(371.0)
United	31.3	309.2	356.1	95.0	(221.9)	(950.0)	(312.1)
USAir	210.0	217.2	2.1	(410.7)	(309.3)	(1,230.0)	(1,400.2)
Total	\$ 118.9	\$ 1,310.3	\$ 140.0	\$ (2,011.0)	\$ (1,947.2)	\$ (6,662.9)	\$ (8,682.9)

Note: Losses are in parenthesis.

Totals may not add due to rounding.

<sup>a</sup>No data available. Eastern ceased operations in January 1991.

<sup>b</sup>Pan Am ceased operations in December 1991. Full-year 1991 and 1992 data are not available. 1991 data reflect January-through-September results.

<sup>c</sup>TWA had an operating loss of \$353.5 million during 1991. Its net profit, therefore, can be attributed to the sale of three of its transatlantic routes to American Airlines for \$445 million.

Source: Compiled by GAO from data supplied by the Air Transport Association.

Table I.2: One-Time Charges for Compliance with Financial Accounting Standard 106

Airline	1992 net income(loss)	FAS 106
American*	\$(935.0)	\$595.0
Northwest	(383.0)	227.0
United*	(956.8)	540.0
USAir*	(1,230.0)	848.4
Total	\$(3,504.8)	\$2,210.4

\*Data shown are for the holding company.

Source: Compiled by GAO from Air Transport Association data.

## APPENDIX II

## APPENDIX II

SELECTED INTERNATIONAL ROUTE SALES BETWEEN  
MAJOR U.S. AIRLINES, 1986-92

Dollars in millions

Buyer	Seller	Route	Price <sup>a</sup>
American <sup>b</sup>	Eastern	Latin American system	\$471
	Trans World	3 U.S.-London routes	445
Delta	Pan Am	European routes	526
	Pan Am	New York-Mexico City	25
Northwest <sup>c</sup>	America West	Honolulu-Nagoya, Japan	15
	Hawaiian	Pacific routes	9
USAir <sup>b</sup>	TWA	2 U.S.-London routes	50
United <sup>b</sup>	Pan Am	Pacific routes	716
	Pan Am	U.S.-London routes	400
	Pan Am	Latin American system, Los Angeles-Mexico City	148

<sup>a</sup>Prices were verified with the airlines that bought the routes. In some cases, the prices include related facilities and assets as well as international route authority.

<sup>b</sup>Price given includes related facilities and assets.

<sup>c</sup>Price given does not include related facilities and assets.

## APPENDIX III

## APPENDIX III

PERCENTAGE OF MAJOR U.S. AIRLINES'  
SYSTEMWIDE REVENUE PASSENGER MILES (RPMS)  
REPRESENTED BY INTERNATIONAL OPERATIONS, 1987 AND 1991

Airline	International operations as percent of total operations		Percentage change in international operations (in RPMS)*
	1987	1991	
America West	0.0	1.9	b
American	12.8	21.6	139.5
Continental	16.3	27.3	73.9
Delta	9.4	15.3	145.3
Eastern	9.2	1.3	(99.3)
Northwest	35.1	42.3	60.7
Pan Am	79.8	71.5	(27.9)
Southwest	0.0	0.0	b
TWA	36.7	35.7	(17.9)
USAir <sup>c</sup>	1.7	3.5	498.2
United	15.5	30.7	142.6
Subtotal: American, United, and Delta	27.1	45.5	142.0
Subtotal: Top three airlines in 1987	58.6	41.0	(1.0)
Subtotal: Top three airlines in 1991	39.3	56.1	105.6

\*An RPM is a revenue passenger mile, i.e., one paying passenger carried one mile.

<sup>b</sup>Not applicable.

<sup>c</sup>USAir's data reflects the airline's acquisition of Piedmont on November 5, 1987.

Source: Compiled by GAO from Department of Transportation data.

## Appendix IV

## Appendix IV

LONG-TERM DEBT AS A PERCENTAGE OF TOTAL CAPITALIZATION, 1986-90

Airline	1986	1987	1988	1989	1990	Average
Pan Am Corp.	99.0	132.3	151.1	272.9	*	131.1
Eastern <sup>b</sup>	90.7	97.3	473.3	(52.9)	(21.8)	117.3
Continental <sup>c</sup>	97.3	85.4	96.3	96.3	197.2	114.5
TWA <sup>d</sup>	94.2	89.8	101.3	114.8	140.6	108.1
America West	81.5	89.0	86.9	84.5	96.7	87.7
UAL Corp.	45.8	32.7	62.7	46.1	42.8	46.0
USAir <sup>e</sup>	24.8	44.5	35.6	44.8	61.8	42.2
AMR Corp.	45.1	45.0	41.0	33.5	42.8	41.5
Southwest	35.3	29.5	35.6	33.4	31.4	33.0
Delta <sup>f</sup>	33.6	26.7	21.0	18.3	29.8	26.2
NWA, Inc. <sup>g</sup>	50.8	34.4	32.1			
Industry average <sup>h</sup>	56.8	54.6	53.6	56.2	73.6	

Note: For years for which no data appear, data were not publicly available.

<sup>a</sup>Pan Am's ratio of long-term debt to total capitalization was infinity in 1990.

<sup>b</sup>Due to Eastern's bankruptcy, 1989 and 1990 data for Eastern are not comparable with earlier data for Eastern or with data for other airlines.

<sup>c</sup>Before December 31, 1986, Continental had \$653.9 million in liabilities subject to Chapter 11 reorganization proceedings.

<sup>d</sup>TWA's data for 1986 and subsequent years reflect the airline's acquisition of Ozark on September 15, 1986.

<sup>e</sup>USAir's data for 1987 and subsequent years reflect the airline's acquisition of Piedmont on November 5, 1987.

<sup>f</sup>Delta's data for 1987 and subsequent years reflect the airline's acquisition of Western on December 18, 1986.

<sup>g</sup>NWA, Inc., was acquired by Wings Acquisition, Inc., on August 4, 1989. Consequently, company reports for NWA, Inc., are not available for 1989 and subsequent years. NWA's data for 1986 and subsequent years reflect the airline's acquisition of Republic on August 12, 1986.

## Appendix IV

## Appendix IV

<sup>a</sup>Industry average data include data for Ozark, People Express, Piedmont, Republic, and Western until their respective mergers.

Source: Julius Malutis, The Financial Condition of the U.S. Airline Industry at Year-End 1990, Salomon Brothers (New York: June 1991), p.8, fig. 10. Data are drawn from company reports.

RELATED GAO PRODUCTS

International Aviation: Measures by European Community Could Limit U.S. Airlines' Ability to Compete Abroad (GAO/RCED-93-64, Apr. 26, 1993).

State of the Airline Industry: Strategies for Addressing Financial and Competition Problems (GAO/T-RCED-93-21, March 10, 1993).

Airline Competition: Strategies for Addressing Financial and Competitive Problems in the Airline Industry (GAO/T-RCED-93-11, Feb. 18, 1993).

Transportation Issues (GAO Transition Series) (GAO/OCG-93-14TR, Dec. 1992).

Airline Competition: Impact of Changing Foreign Investment and Control Limits on U.S. Airlines (GAO/RCED-93-7, Dec. 9, 1992).

New Denver Airport Followup (GAO/RCED-92-285R, Sep. 14, 1992).

Computer Reservation Systems: Action Needed to Better Monitor the CRS Industry and Eliminate CRS Biases (GAO/RCED-92-130, Mar. 20, 1992).

New Denver Airport: Safety, Construction, Capacity, and Financing Considerations (GAO/RCED-91-240, Sep. 17, 1991).

Aviation Noise: Costs of Phasing Out Noisy Aircraft (GAO/RCED-91-128, July 2, 1991).

Airline Competition: Effects of Airline Market Concentration and Barriers to Entry on Airfares (GAO/RCED-91-101, Apr. 26, 1991).

Airline Competition: Weak Financial Structure Threatens Competition (GAO/RCED-91-110, Apr. 15, 1991; GAO/T-RCED-91-6, Feb. 6, 1991).

Airline Competition: Fares and Concentration at Small-City Airports (GAO/RCED-91-51, Jan. 18, 1991).

Airline Competition: Passenger Facility Charges Represent a New Funding Source for Airports (GAO/RCED-91-39, Dec. 13, 1990).

Airline Deregulation: Trends in Airfares at Airports in Small and Medium-Sized Communities (GAO/RCED-91-13, Nov. 8, 1990).

Airline Competition: Industry Operating and Marketing Practices Limit Market Entry (GAO/RCED-90-147, Aug. 29, 1990).

Airline Competition: Higher Fares and Reduced Competition at Concentrated Airports (GAO/RCED-90-102, July 11, 1990).

Effects of Airline Entry Barriers on Fares (GAO/T-RCED-90-62, Apr. 5, 1990).

Airline Competition: DOT and Justice Oversight of Eastern Air Lines' Bankruptcy (GAO/RCED-90-79, Feb. 23, 1990).

Barriers to Competition in the Airline Industry (GAO/T-RCED-89-65, Sep. 20, 1989, and GAO/T-RCED-89-66, Sep. 21, 1989).

Airline Competition: DOT's Implementation of Airline Regulatory Authority (GAO/RCED-89-93, June 28, 1989).

Competition in the Airline Computerized Reservation System Industry (GAO/T-RCED-88-62, Sep. 14, 1988).

## UNITED AIR LINES, INC.

Stephen M. Wolf  
Chairman and Chief Executive Officer

June 21, 1993

The Honorable Jack Brooks  
Chairman  
Economic and Commercial Law  
Subcommittee of the House  
Committee on the Judiciary  
B353 Rayburn House Office Building  
Washington, D.C. 20515

Dear Mr. Chairman:

I am sorry that I was unable to attend the Subcommittee's recent hearings concerning competition in the airline industry. It is, of course, a subject to which United has devoted a great deal of thought.

In conjunction with the proceedings of The National Commission To Ensure A Strong Competitive Airline Industry, United prepared the attached paper setting forth our views on the state of the industry and how we believe competitiveness can be assured over the long term. I believe that these views would be helpful to you and your fellow committee members in your consideration of this important subject. I, therefore, request that they be included in the record of these proceedings.

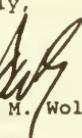
We feel very strongly that any analysis of our industry must constantly distinguish between the domestic and international aspects of air transportation. As we explain in our submission, the primary difficulty affecting the domestic operations of an established carrier such as United stems from its cost structure. That is a problem that must be cooperatively addressed by the carrier and its employees. The Government's most useful role in that regard would be to acknowledge that problem in some detail, and by so doing help create an environment for a timely labor-management solution. Further, on a governmental level, United believes that something must be done to reduce the burden on air carriers of a growing variety of taxes, fees, unnecessary regulations and an air transportation infrastructure in dire need of improvement. In addition, we believe that the adverse effects on the industry as a whole of prolonged air carrier operations in bankruptcy warrant serious analysis. Our submission addresses those points.

In the international arena, the most important aviation issue from the standpoint of the U.S. economy is the need to expand U.S. carrier opportunities to employ their competitiveness in foreign markets. In this regard, we strongly urge the development of a pragmatic international aviation strategy. We believe that in this increasingly global transportation marketplace, there is no more important aviation priority for the U.S.

Expansion of U.S. services abroad produces immediate and substantial domestic benefits in the form of U.S.-based jobs, a healthier and more competitive domestic air transportation system, and more and better services for U.S. passengers and shippers. The Government must, therefore, become more proactive; it must reaffirm its commitment to a liberal international aviation policy. As a major trading partner and an enormous market for countries around the world, the U.S. must make it clear that it will not tolerate increased protectionism. Foreign governments should be on notice that moves to constrain services of U.S.-flag air carriers will adversely affect their overall trade relationship with the U.S.

We at United appreciate the concern the Subcommittee has shown for our industry. If United can of any assistance to the Subcommittee and its staff in evaluating these issues, please let us know at once.

Sincerely,



Stephen M. Wolf

Attachment

Presentation of  
UNITED AIR LINES, INC.

to the

National Commission To Ensure  
A Strong Competitive Airline Industry

June 14, 1993

The second, but far more extensive role of the Commission will be in identifying areas in which Government interference in the marketplace is unnecessarily encumbering air carrier operations. The Commission's analysis and recommendations in this area can produce immediate and positive results.

Eliminate Excessive Fees and Regulations. The lack of any requirement to cost-justify fees and regulations imposed on air carriers has resulted in an unreasonable burden that depresses domestic demand artificially and will eventually place us at a competitive disadvantage internationally.

Notable examples include:

- The 10% passenger ticket tax should be rolled back to 8%, suspended or repealed in light of the continuing surpluses in the aviation trust fund. Last year, while United was incurring almost \$1 billion in losses, it paid over \$1 billion in taxes and fees, including ticket taxes amounting to \$638 million.
- United pays an estimated \$7 million per year for new airport access security provisions to satisfy standards that international carriers serving the same routes do not have to meet.

United spends over \$1 million annually to drug test 18,500 employees although no pilot has ever tested positive, with the government now planning to implement a separate program of alcohol testing.

Regulatory fees paid to the customs and immigration services and the Department of Agriculture for inspections and processing cost United over \$47 million annually.

In 1992, United paid \$12 million in Passenger Facility Charges (PFCs). That amount will increase this year. The danger is that relationships between the PFCs and the actual transportation need for projects they are funding will quickly become attenuated. This the industry clearly cannot afford; close Government analysis is essential.

Hawaii can perhaps serve as a microcosm for many of the problems imposed on our industry. Despite having an economy that is extraordinarily dependent upon interstate air transportation, the state is embarked on a path which will inevitably reduce the amount of such service it receives. By attempting to reregulate air transportation within the state, and by imposing a series of discriminatory fees and charges for the purpose of subsidizing local carriers, Hawaii is undermining the very services that are essential to its economic survival. The reregulation effort is inconsistent with the federally-mandated market-driven domestic aviation industry, and would require amendment of the Federal Aviation Act. It should not be permitted to go forward.

Reduce the Aggregate Tax Burden. The cumulative effect of federal, state and local taxes has saddled the airline industry with an oppressively high tax bill, even as carriers lose billions of dollars. Relief is warranted.

- Limit the impact of a proposed energy or other broad-based transportation tax on airlines. Full implementation of the BTU tax would cost United an estimated \$150 million annually; the broad-based transportation tax currently proposed by Senator Breaux as an alternative could cost United \$160 million annually.

Reform the Alternative Minimum Tax (AMT) to permit the use of minimum tax credits to offset AMT liability, permit full carry forward of AMT Net Operating Losses, and improve AMT depreciation to allow 150% declining balance method over 7 years.

Exempt airline per diem from the proposed meal and entertainment deduction limitation. Airline per diem expenses are not a true entertainment expense, but represent the cost of meals for crew layovers which are necessary to comply with federally mandated rest periods before returning to duty. The proposed increased disallowance would result in an additional tax burden of approximately \$7 million annually for United.

Rationalize the Allocation of Slots at Congested Airports. Rules governing access to capacity constrained airports are unfair and inefficient. Automatic withdrawal of slots from domestic operations to meet requests for international carrier operations should cease.

- Each slot that United deploys in its hub system at O'Hare generates, on average, nearly \$5 million in air transportation revenues annually.
- As a result, United estimates that the full-time slot withdrawals it absorbed during 1992 caused the loss of over \$130 million in revenue.

Reform Bankruptcy Laws. Although the right to bankruptcy protection should be preserved, the increasing period of time that distressed carriers remain in bankruptcy along with their pricing behavior when in bankruptcy should be addressed.

- In 1992, the bankrupt carriers represented nearly 18% of domestic capacity; nearly 70% of United's domestic route system was affected by the bankrupt carriers.
- An operating cost comparison shows that, on average, the bankrupt carriers have a \$2 billion annual cost advantage over United.

**International Markets**

Develop and Articulate an International Aviation Strategy. The lack of a clear U.S. strategy on international aviation has created an incentive for our aviation partners to continually test the limits of U.S. willingness to retreat from its goal of liberalization. The cornerstone of a U.S. strategy must be to refuse to reward those countries that renounce their bilateral agreements or otherwise seek to restrict U.S. access to their markets.

Negotiate Truly Reciprocal Commercial Opportunities. Reciprocity of commercial opportunities is the key to successful negotiations, and this concept must be understood in terms of the individual market at issue. Commercial opportunities of equivalent value should be the currency of exchange, not theoretical rights that cannot translate into real world competitive opportunities. The U.S. should never give away something for nothing (e.g., international slot rule at O'Hare) or conclude negotiations that provide for markedly imbalanced opportunities (open skies with the Netherlands).

Emphasize the Establishment of New Commercial Opportunities. The U.S. historically has been more interested in exporting its aviation ideology than in establishing new commercial opportunities for U.S. carriers wherever possible. The recent U.S. government decision to delay any liberalization of the U.S.-U.K. aviation relationship until a completely new agreement has been negotiated follows this pattern and harms U.S. carriers' competitive position.

Treat Aviation Within a Broader Trade Policy Framework. The insular bilateral framework for addressing international aviation policy has outlived its usefulness as our major trading partners move to place new restrictions on U.S. carriers' access to their markets.

Recognizing the key strategic role of the aviation industry requires that these issues be addressed within a broader trade context. For example, countries like Japan and Thailand with large trade surpluses simply should not be able to limit U.S. carrier rights illegally or arbitrarily and expect to be able to continue to benefit from an otherwise open trading relationship.

AIR TRANSPORTATION: A STRATEGIC U.S. INDUSTRYOverview

In the late 1970s two related decisions, the first to deregulate the U.S. domestic industry, the second to liberalize international air transportation, precipitated a chain of events which continues to reshape the nature of the U.S. air transportation industry.

With the deregulation of a major market for the first time in aviation history, the U.S. was flooded with new entrants and a broad array of business strategies that produced dramatic increases in the demand for air service during the 1980s. In the international marketplace, movement toward more liberal bilateral air service regimes produced major expansions in service options, lowered prices and precipitated movement toward the development of integrated, global airline systems. In that process, air transportation came of age. It emerged as an essential element of the nation's, indeed the world's, economic infrastructure. It sustains the vital flow of people and goods in the domestic economy and has become an integral factor in the advancement of U.S. interests in the world market. It is from this perspective that Government needs to develop its policies on aviation.

While the importance of air transportation is acknowledged, it must also be recognized that the system is in trouble. The domestic industry faces fundamental structural problems. Foremost among these is the need of the established, pre-deregulation carriers to bring their costs of doing business into line with the rapid changes in demand and revenue generating potential of the domestic air travel market.

In the international market, U.S. carriers have achieved significant successes as efficient producers of air service. Their comparative advantages, however, have not been fully exploited. A rising tide of foreign protectionism, if unchecked, threatens to undo much of what the free trade-oriented U.S. international aviation policies have achieved.

#### The Domestic Market

The record losses incurred by the airline industry over the past three years are, to some degree, due to the economic recession and a lackluster recovery. But for the established airlines, the issues go deeper and raise fundamental questions about the costs and structure of their operations.

Since domestic deregulation, the market has evolved into essentially two distinct segments. On the one hand are carriers -- primarily new entrants -- that are capable of offering basic transportation services at relatively low fares. Also included in this group are established carriers that are operating under protection of Chapter 11 of the Bankruptcy Code and are thereby relieved of the costs of meeting their pre-bankruptcy financial obligations. These Chapter 11 carriers enjoy a \$2 billion annual cost advantage over United. They are able to price their services at marginal cost levels, thereby introducing substantial distortion into the industry fare structure. In 1992, such carriers accounted for almost 18% of U.S. air travel; their pricing actions directly affected over 70% of United's domestic route system.

In contrast, there are the long-established carriers which account for nearly 80 percent of the nation's airline capacity. These "full service" carriers, including United, evolved in an environment of strict Government regulation. Over many years, they developed integrated route systems serving markets of virtually all distances and densities. At the same time, a wide range of costly business practices emerged including patterns of labor wages and work rules, that are a serious handicap for these carriers vis-a-vis their low-cost competitors. For example, on average a Southwest pilot works 40% more hours per month than a United pilot, while the United pilot is paid, on average, 17% more than his or her counterpart at Southwest. The combined effect of these two factors is that United pays 64% more than Southwest for an hour of pilot time. Wage and productivity disparities such as these produced system labor costs for United for 1992 of 3.3¢ per ASM; Southwest's were only 2.5¢.

During the 1980s, the established carriers employed a variety of strategies to offset the competitive disadvantages caused by their higher costs of operation. These included implementation of hub-and-spoke route networks that produce substantial efficiencies; use of more effective reservations and ticketing processes made possible by new computer technologies; and the introduction of innovative marketing tools such as frequent flyer programs which stimulated frequent travel and sophisticated yield management systems that enabled carriers to maximize revenues by matching seat inventories with a wide range of service and price options on a real time basis.

While these strategies served the carriers well in the 1980s, it is increasingly apparent that the long-term financial prospects of the major carriers require more. Thus, throughout the industry, a thorough, top-to-bottom review of the methods and costs of providing air service is underway. This review has significant implications for virtually every sector of the industry: the airlines, aircraft manufacturers, as well as other suppliers, labor and Government. It is now quite apparent that without prompt and effective cost containment and productivity enhancements, the decline in the nation's established domestic air transportation system will not be arrested. Without action on costs and productivity, the industry will face another phase of painful transition resulting in further carrier failures and all of the job losses and economic disruptions associated with such events.

The industry's recovery is not going to be achieved by waiting passively for a general economic upturn. The domestic market has now matured and the demand for air transportation is changing. The large growth rates experienced over the past three decades are not likely to be repeated. Moreover, low-cost, no-frills carriers and other niche players have become significant factors in the system, a trend that will accelerate as the economic recovery gains speed. This means that in market after market, established carriers ultimately face a choice: either reduce costs and compete effectively or abandon the field. United Airlines is committed to the first option.

This is a task for the airlines, not for the Commission. United has already taken significant steps to reduce costs and increase productivity, and the process is a continuing one.

- Capital expenditures on aircraft and other facilities and equipment are being reduced and deferred.
- Employee head counts are being trimmed and corporate officer and staff salaries have been reduced. Agreements are also being sought from organized labor to improve productivity and bring unit labor costs more into line with those of United's lower-cost competitors. These include Southwest Airlines and other new entrants which now serve markets accounting for the bulk of United's domestic revenues.
- Where internal operations cannot be conducted efficiently, goods and services are being purchased on a contract basis at lower cost. In certain cases, this means the disposition of existing functions such as United's flight kitchens.

These and similar cost reduction measures affecting all areas of operations are under way; they do not require Government assistance or intervention. Indeed, it is vitally important that Government consciously avoid actions which will retard restructuring such as legislation that would upset the existing management-labor collective bargaining balance. In

the last analysis, management and labor must reach mutual understandings on the depth of the problems facing the airlines and the options that are realistically available. Change will be inevitable and, in many instances, difficult. However, these issues need to be resolved through the collective bargaining process and not by Government fiat. The Commission's role should be one of identifying the problems facing the carriers and their employees in this area. This objective process may, in turn stimulate the cooperative environment needed for meaningful change to occur.

There are, in addition, several areas where Government can, and should, offer direct help by reducing the cost burdens imposed on airlines, their passengers and shippers.

- Federal, state and local taxation on aviation activity is excessive and, in the aggregate, places severe burdens on carrier resources. In 1991, for example, the industry as a whole lost \$2 billion yet paid over \$7 billion in taxes and fees. In 1992, United alone lost almost a billion dollars yet paid taxes and fees of over \$1 billion. (Those taxes are listed in the attachment to this document). Policies such as the application of the Alternative Minimum Tax (AMT) on carriers suffering financial losses clearly need to be reviewed as do the myriad other Federal, state and local taxes and charges which raise costs and inhibit demand.

The proposed energy tax would cost United an estimated \$150 million annually; the broad-based transportation tax alternative would cost United \$160 million per year. Neither United nor the industry as a whole should be forced to bear such an extreme tax burden. United already pays \$.395 tax on every gallon of aviation fuel.

The Alternative Minimum Tax should be reformed to permit the use of minimum tax credits to offset AMT liability, to permit full carry forward of AMT net operating losses and to improve AMT depreciation to allow a 150% declining balance method over a seven year period.

Airline per diem paid to crews should be excluded from the proposed meal and entertainment deduction limitations. Airline per diem expenses are not entertainment expenses. They represent the cost of meals for crew layovers which, in turn, are necessary to comply with federally mandated crew rest requirements. As the Administration's tax proposal now stands, the disallowance would impose an additional tax burden of \$7 million annually on United.

- Regulations, fees and charges are imposed by Governments at all levels with only passing regard for meaningful cost-benefit analysis in terms of their impact on the industry.

- Significant in its adverse economic consequences is the FAA's automatic withdrawal of domestic slots to meet requests of international air carriers. During the summer of 1992, United lost 28 full time slots through this procedure. Each domestic slot that United deploys at O'Hare generates on average nearly \$5 million in air transportation revenues annually. For 1992, the economic loss to United attributable to slot withdrawals amounted to over \$130 million.
- United pays an estimated \$7 million for new airport access security provisions to satisfy federal standards; foreign carriers serving the same U.S. airport need not satisfy those requirements. The burden here must be balanced.
- The Government's drug testing rules must be reevaluated. United spends in excess of \$1 million per year to test 18,500 employees although no pilot has ever tested positive. Rather than reduce the burden, however, the Government has plans to expand it by adding a separate testing procedure for alcohol.
- The Government continues to pour tax dollars into developing Microwave Landing Systems (MLS), while technology, in the form of the Global Positioning System (GPS), has passed it by. Rapid focus on

GPS instead of the microwave system could save the industry and the taxpayers considerable amounts.

- The imposition of fees and regulations without cost-benefit analysis is also a serious state and local problem for the air carriers.

- In 1992, United paid \$12 million in Passenger Facility Charges (PFCs). That amount is certain to increase as local authorities tap into this new source of revenue for airport improvements. The risk is that the ability to raise funds in this manner will become a temptation hard to resist for local officials. Detailed Government scrutiny of requests for PFCs is absolutely essential.
- Hawaii is a perfect example of a myopic approach to revenue enhancement measures. That state is uniquely dependent upon interstate and foreign air transportation to support its economy. Yet, through an ill-conceived attempt to protect local carriers, Hawaii has proposed to reregulate competition and to impose airport fees and local taxes which discriminate against interstate carriers. The mainland-Hawaii air transportation market is extremely fragile, yields are depressed and traffic is weak. Burdens of the type now being imposed on the interstate carriers who serve the market can only precipitate a

withdrawal of additional capacity to the sharp disadvantage of the Islands and their tourism-driven economy.

- The Federal bankruptcy laws are being administered in a manner which severely distorts air travel markets and inflicts economic damage on the financially solvent sectors of the industry. The Chapter 11 reorganization process needs to be streamlined and expedited so as to minimize the impact of such phenomena as open-ended, below-cost pricing by bankrupt carriers. The damage done to the industry as a whole by a major carrier allowed to operate for over three years under bankruptcy protection cannot be ignored.

These are only a few examples of how Government is having a profound, adverse effect on the financial health of the airline industry by increasing costs, diminishing productivity and distorting the function of the marketplace. In the last analysis, Government policymakers need to view the airline industry from a fresh perspective. They need to tailor public policies in a way that accommodates the commercial realities of the industry. Traditional regulatory approaches which produce uncoordinated and costly micro-management should be avoided. Instead, emphasis should be placed on the fundamentals of what it takes to produce and sustain an efficient air transportation system that is vital to the growth and development of the nation's economy.

The International Market

Data suggest that the domestic air transportation market has matured following three decades of rapid expansion. As with other mature markets, expansion by one producer is now largely matched by a decline in another. This means that if the U.S. air transportation industry is going to continue to provide a growing base of high-paying U.S. jobs, it must be able to operate internationally where the market is still expanding rapidly and where U.S. carriers enjoy a substantial cost advantage over their foreign competitors.

The ability of U.S. carriers to compete abroad was greatly facilitated by the Government's decision in the late 1970's to pursue liberalized international aviation agreements. In addition, over the past several years, carriers that provided the bulk of U.S.-flag service in international markets prior to deregulation have been replaced by carriers that have capitalized on the strengths of their newly developed domestic hub and spoke networks to support an expanded volume of international services over an increasing number of routes.

This changing of the guard in international air transportation has been a major foreign trade success for the United States. After decades of decline, the U.S. flag carrier share of U.S. international air transportation is again on the rise. By 1992, the U.S. carrier share of passenger traffic moving between the U.S. and foreign countries had reached 53 percent, up from less than 48 percent five years before.

The replacement of Pan American by United over Pan Am's Pacific routes is a prime example of what can be accomplished if strong efficient competitors are permitted to replace weaker, less effective carriers. In 1985, Pan Am's Pacific passenger revenues totalled \$617.7 million. In 1992, under United stewardship, that same Pacific authority was generating \$2.86 billion in annual revenues, with over 71 percent realized at foreign points of sale.

This type of performance, in turn, translates directly into domestic jobs. For example, over the past five years, United Airlines' domestic job base has grown by 16,000 workers, almost entirely as a consequence of international expansion. To view this from a slightly different perspective, although over 35 percent of United Airlines' total revenues are now generated from international operations, only 7 percent of United Airlines' jobs are outside of the U.S. The ability to add substantial numbers of secure, high paying jobs to the U.S. economy is the reason the U.S. should be concerned about whether its international transport needs are met by U.S. or foreign carriers. The latter may be able to offer passengers or shippers a service comparable to that of a U.S. carrier, but most of the jobs which that service sustains will be located overseas.

As mentioned, the major carriers are under severe pressure from low-cost carriers in those domestic markets that lend important support for international expansion. On the other hand, protectionist moves abroad are increasingly restricting U.S. carrier access to foreign markets. If left unchecked, these trends could mean a significant reduction in the range of

competitive services available to the domestic passenger because of stagnation in international services on which the U.S. industry's growth largely depends.

The Government must use its best efforts to halt the breakdown of pro-competitive aviation policies that rely on market forces, rather than Government regulation, to shape the course of international air transportation. While U.S. carriers have, thus far, been extremely successful in developing global air transportation networks, this process is now at risk. In light of the current trend toward protectionism, the U.S. cannot continue on a "business-as-usual" course. Strong responsive action is in order. The U.S. must make it clear to trading partners that denunciation of an agreement is not a cost-free exercise. The U.S. must also make it clear to its trading partners that moves toward increased protectionism in air transportation will not be viewed in isolation but will have a direct impact on other aspects of their trading relationship with the United States. In other words, a vital element of the nation's distribution system -- international air transportation -- is threatened and the U.S. must do what is needed to fix the problem.

Without doubt, European and Asian flag carriers are experiencing substantial economic difficulties as a result of the world-wide recession. For many of these carriers, the easiest perceived solution for their financial problems is to limit or reverse the expanding presence of U.S. carriers in world markets. Countries are threatening to renounce their agreements with the U.S. in the hope of replacing them with a protectionist Bermuda II-type aviation agreement. This makes it all the more important to replace this anachronistic

agreement with a modern, liberal one. We should not wait a year to achieve this goal.

Where possible, immediate opportunities should be taken to signal the world both our objectives and as to the urgency with which we intend to pursue them. It is essential that the U.S. move now to restore the momentum toward open international markets without which orderly and efficient growth in this vital segment of the transportation system will not be possible.

If restriction-minded European countries perceive that the U.S. is moving toward a much more open relationship with the U.K., they will come to recognize the greater risks of maintaining protection for their own carriers. Not only will their carriers be unable to keep pace with British Airways and the U.S. carriers in the race to "globalize" their operations, but the "protection" achieved will be far less effective. For example, liberal access to the Netherlands, Belgium, Luxembourg and the U.K., coupled with the growth of an integrated European high speed rail network, could effectively circumvent many of the barriers upon which France and Germany hope to rely. In short, the effect of a successful liberalization of the U.S.-U.K. agreement will not be lost on other European countries, and it should move them to a reevaluation of their strategies.

As for Asia, U.S. strategy must be designed to hold the line on rights now held by the U.S. Japan, of course, is central to this path. Its enormous trade surplus provides the U.S. with substantial negotiating leverage for at least maintaining the status quo in the area of trade in air transportation. As an essential part of the global infrastructure on which the

economic welfare of the U.S. depends, the U.S. should not be reluctant to link directly progress in the U.S.-Japan aviation relationship with other trade issues of vital interest to Japan. Japan's cynical attempts to portray themselves as free traders while seeking numerical caps and other regressive restrictions on aviation should not be countenanced.

As these strategies take effect, first with the U.K., and then with France and Germany in Europe, Japan should begin to recognize that its insistence on a protectionist agreement with the U.S. will block its carriers from the global access they will need. If Japan's carriers fail to keep pace with the large U.S. and European air carriers, their economic viability will be weakened and their decline may well jeopardize other vital Japanese trading interests.

Reciprocity is the key to successful negotiations. Commercial opportunities of equivalent value should be the currency of exchange, not theoretical rights that cannot translate into real commercial opportunities. The U.S. should never give away something for nothing -- as it is now doing with its international slot policy at Chicago's O'Hare International Airport. Nor should it conclude negotiations that provide for unbalanced opportunities -- access to the U.S. market, for example, means access to \$100 billion in air transportation revenues. Reciprocal access to the U.K. market would mean access to only \$19 billion in revenues. Standing alone, this sort of trade would not come near a common-sense definition of "balance." That is why any agreement with the U.K. must be evaluated

in the context of its ability to contribute toward a broader agreement between the U.S. and the European Community.

#### Conclusion

Air transportation for the United States is an economic life-line for people and products. It has grown to the point where, both domestically and internationally, it is an essential factor in the economic well-being of the United States.

This essential industry is in trouble, and appropriate remedies must be found, both by the carriers themselves and by Government. Inaction and gridlock in these matters, whether in the private or public sectors, could produce serious harm for the U.S. economy.

When all is said and done, the appropriate Government response in the domestic market should be one that identifies the cost issues facing the U.S. domestic industry and allows market forces to shape the industry's course. Resolution of the current economic problems facing the industry must, in large measure, be achieved by the carriers themselves through a variety of measures designed to reduce costs and restructure their operations to meet the needs of a changing market. For its part, the Commission should identify and publicize these problems. It must, we believe, urge as the appropriate Government role, the adoption of policies which lessen the regulatory and fiscal burdens on carriers and foster an environment where carriers can fairly and effectively compete.

In the international arena, the Commission should urge the Government to be proactive. The Government must reaffirm its commitment to a liberal, open skies policy as the premise for its aviation relationships with all countries. As a major international market and trading partner for countries in both Europe and Asia, the U.S. must make it clear that it will not tolerate increased protectionism, and that moves to constrain services of U.S. flag carriers will adversely affect the overall trading relationship.

# # #

### THE INDUSTRY IS SADDLED WITH EXCESSIVE FEES

- Following deregulation, federal, state, and local governments have levied an increasing number of taxes and fees on the airlines.
- For example, in 1991, a year in which industry lost \$2 billion, industry taxes and fees totalled over \$7 billion.

<u>Tax or Fee</u>	<u>Rate</u>	<u>Per</u>	<u>1991 Industry Exp (\$ Millions)</u>
Ticket tax	10.0%	\$ of revenue	4,376
Cargo tax	6.25%	\$ of revenue	221
Jet fuel tax	5.0%	\$ of expense	625
Int'l departure tax	\$6	passenger	217
Customs fee	\$5	passenger	150
Immigration fee	\$5	passenger	133
Agriculture fee	\$2	passenger	70
Pax facility charge	\$3	passenger	<u>1,200</u>
Total			\$ 7,042

- In 1992, United lost almost \$1 billion yet, taxes and fees for United in 1992 totalled \$1.06 billion and represented 8.3% of revenue.

	<u>Amount (\$ Millions)</u>	<u>% 1992 Revenue</u>
Ticket Tax	\$ 637.9	5.0%
Payroll Taxes	172.4	1.4%
State and Local Property Taxes	60.9	0.5%
Fuel Tax - Federal and State	44.9	0.4%
Sales and Use Taxes	30.4	0.2%
Immigration Fee	29.4	0.2%
International Destination Tax	26.6	0.2%
Customs Fee	16.4	0.1%
Passenger Facility Charges	12.0	0.1%
Federal Income Taxes	8.1	0.1%
Cargo Tax	7.6	0.1%
Miscellaneous	4.6	0.0%
State and City Income Taxes	2.9	0.0%
Foreign Franchise Taxes	1.2	0.0%
State Franchise Taxes	0.6	0.0%
Total Taxes and Fees	\$ 1,055.9	8.3%

<u>Regulatory Fees (\$ Millions)</u>	
APHIS fees	\$ 1.2
Immigration fines	0.7
Customs govt agency expense	0.3
Drug testing	<u>1.0</u>
Total	\$ 3.2

## APPENDIX 2.—RESPONSES TO ADDITIONAL QUESTIONS FOR THE RECORD

## MR. BROOKS' QUESTIONS FOR THE RECORD FOR PROFESSOR DEMPSEY

1. *Do frequent flyer incentives by established carriers impact adversely upon potential entrants?*

Answer. Yes. Seventy-five percent of travel agents report that business customers chose to fly a particular airline more than half the time because of their membership in that carrier's frequent flyer program. Obviously, a megacarrier which can offer its frequent flyers free trips to exotic destinations in Europe, Asia or Latin America will have a significant competitive advantage vis-a-vis a smaller upstart airline which can offer its frequent flyers free trips to only a few domestic cities.

2. *Some contend that the hub phenomenon has decreased competition in the markets in which a hub is located. How have consumers been affected by the restructuring caused by hubs.*

Answer. Hubbing is the dominant megatrend on the deregulation landscape. Paradoxically, hubs are a both curse and a blessing. Consumers who live in cities whose airports are concentrated hubs enjoy ubiquitous nonstop service throughout the nation, but pay a price well above competitive levels because of the market power enjoyed by the dominant airline. Consumers who do not live in hubs find they must often fly circuitously through hubs to get to their preferred destinations, squandering much time in the process.

From the airlines' perspective, hubs offer significant marketing advantages and networking efficiencies. Yet they are high-cost means of distributing passengers. Hubbing results in lower equipment and labor utilization and higher fuel consumption. It is telling that the only major airline which has made a profit during the last several years is Southwest, which shuns hubbing in favor of a linear route system.

3. *You had previously written that vigorous antitrust enforcement against the many airline mergers during the 1980s would have helped preserve airline competition. However, you testified to the subcommittee that "the economic condition of the industry would be worse today had the antitrust laws been effectuated in order to disapprove these mergers." Could you elaborate on the factors that accounted for your change in positions?*

Answer: During the Reagan-Bush administrations, in a fit of the prevailing laissez-faire theology of the era, the DOT approved all 21 mergers submitted to it, thus leading to much higher levels of national concentration, and at three cities (i.e., Detroit, Minneapolis/St. Paul and St. Louis), much higher levels of hub concentration. However, assuming everything else had occurred that did occur, had Northwest not acquired Republic, and had TWA not acquired Ozark, Northwest and TWA would likely not be alive today to compete with the remaining megacarriers.

Without a significant comprehensive legislative package to restore the financial health of the industry, these and several other major airlines may not survive in any event, irrespective of the degree of antitrust scrutiny. The financial crisis in the industry, much of it unfortunately created by deregulation, reluctantly compels me to support consolidation as a means to preserve industry health, with the hope that when all the dust settles we will be left with a sufficient number of healthy airlines that we need not resurrect public utility regulation to protect the public interest.

However, like one of the major airline CEOs, I am increasingly pessimistic that we can have a strong *and* competitive airline industry.

Can the National Commission to Ensure a Strong Competitive Airline industry fulfill its promise to find a comprehensive solution to the airline industry's woes, or is it doomed to rearranging the deck chairs on the Titanic?

The mission itself is formidable. As one airline CEO testified before the Commission, "I am increasingly pessimistic that the airline industry can be both strong *and* competitive."

In other words, the airline industry could be weak and competitive, and it is. It might one day be strong and concentrated. More likely, it will degenerate into something sadly described as weak and concentrated.

The 1990s will be an even more difficult decade for the airline industry than the 1980s, for now the industry is leveraged to the teeth, its credit rating has dropped into a black hole, and the cost of capital will crush operating profits, likely leading to a prolonged era of bankruptcies, labor-management acrimony and an aging, geriatric fleet.

The conventional wisdom is that deregulation is not to blame – the financial crisis is a mere by-product of recession and the spike in fuel costs precipitated by the Persian Gulf War, and some rotten management.

Rubbish. The airline industry has long exhibited a chronic inability to price its product above costs, a tendency radically worsened by deregulation. Too briefly, this is true because airlines are capital intensive, labor intensive, fuel intensive, safety intensive, market a product with no shelf life, oversupply that product to satiate consumer demands for frequency, and offer the price of the lowest-cost provider, denying adequate load factors to all. In this intensely competitive industry, individually rational behavior is collectively irrational.

As the attached chart reveals, the industry's profit margin from 1960 to 1977 was a modest 2.4%, well below the average profit margin of all industry, which ranged between 4% and 6%. But a regulated industry can tolerate a lower profit margin because of less risk. In the early 1970s, neither the onslaught of enormous wide-bodied capacity, the recession, and the enormous spike in fuel with the Arab Oil Embargo (ironically, the same economic conditions of the last three years) bankrupted a single major airline.

Briefly, during the regulatory reform period (1977-78) profits improved, but fell radically once deregulation set in. From 1978-89, the industry's average net profit margin fell to a paltry 0.75%, radically worse than the pre-deregulation period. Add in the last three years, and the profit margin since 1977 drops to a negative 2.3%.

Just to restore the balance sheets of the big three – American, United and Delta -- to respectable levels would take some \$15 billion, about four times the total accumulated profit the entire industry earned from the Wright Brothers flight in 1903 until 1988. As we all know, that accumulated profit is long gone.

And how will the industry ever attract the capital it needs to re-equip what is now the oldest fleet in the developed world – some \$130 billion in capital requirements, a

sum exceeding the foreign debt of Brazil, Latin America's greatest debtor nation? It cannot without a comprehensive legislative solution to the problem.

In order to find an appropriate cure for a disease, one must first properly identify its cause. So long as the conventional wisdom tenaciously insists that deregulation is a splendid success, there will be no comprehensive solution.

The conventional wisdom includes wildly overstated notions of consumer savings -- some \$6 billion annually according to the Brookings Institution, a sum calculated on some very wild assumptions (e.g., that had deregulation not occurred the industry would have still had sharply increased debt service, lease payments, travel agent commissions and the higher fuel consumption, and lower equipment and labor utilization caused by hubbing). The gross misinformation on this point cripples intelligent discussion about solutions to the crisis in air transportation.

That is not to say we need re-regulate under the 1938 public utility model. That approach may have been appropriate then, but not now. Tragically, Alfred Kahn was true to his promise. The eggs have been so scrambled that they can never be put into their shells again. The industry's cost structure is no longer relatively homogeneous, and cost based price regulation would be extremely difficult.

It is to say that regulatory reform of the 1977-78 era was a very good idea. Pity that its successes in providing the industry pricing and entry flexibility (which allowed carriers to rationalize their operations, tap the elasticities of demand to fill seats which otherwise would have flown empty, and thereby enjoy healthy profits while consumers enjoyed price savings) was misinterpreted as proof positive of the potential benefits of deregulation. If a couple of aspirin can cure a headache, imagine what a whole bottle will do? Or a case?

Alfred Kahn insists there is no middle ground between laissez faire deregulation and public utility regulation. More rubbish. As a student of economic regulation Kahn should know we regulate part way in railroads, telecommunications, and broadcasting, and do a much better job than if we adopted either extreme.

Succinctly stated, here is what a new regime of managed competition might include:

1. Regulatory and tax relief. Cost/benefit scrutiny of all regulations, and some roll back in taxes.
2. Fitness. Set prospective debt-to-equity standards prohibiting LBOs and providing rigorous review of carriers in financial trouble.
3. Bankruptcy. Shorten the Chapter 11 period and require that new management replace the management team that put the company in bankruptcy.
4. Agreements. Give antitrust immunity to carriers to rationalize capacity and airport utilization.
5. International aviation. Barter routes more aggressively, giving access only to nations offering equivalent opportunities.
6. Loan guarantees. Use a slice of the trust fund to guarantee the purchase of one new seat for every two retired. Partially finance it with a tax on redeemed frequent flyer mileage.

7. Pricing simplification. Reduce rates to four tiers, as the EEC has done.
8. Pricing discrimination. Eliminate corporate discounting.
9. Travel agent commission. Require that commissions be filed and be reasonable.
10. New routes. Award a three-year exclusive franchise to any carrier seeking to serve a nonstop market not now being served.
11. Mergers and acquisitions. Allow measured consolidation, with weaker airlines folded into stronger airlines.

With a comprehensive legislative solution, a sufficient number of carriers may survive that we need not re-impose public utility regulation.

Without a comprehensive legislative solution, the financial health of the industry will continue to deteriorate. One day, we may be forced to roll the surviving patients into the operating room for major reconstructive surgery. Someone better dust off the plans that created Amtrak.

#### MR. FISH'S QUESTIONS FOR THE RECORD FOR PROFESSOR DEMPSEY

1. *There are many other industries where businesses not in bankruptcy must compete with companies in reorganization. Are there policy reasons for viewing the airline industry as a special situation and concluding that the automatic stay inappropriately disadvantages healthy carriers?*

Answer: Unfortunately, there are virtually no healthy carriers left. Nearly all the industry's debt has been downgraded to "junk" status. If the airlines were savings and loan institutions, they would be put in receivership and liquidated.

The airline industry is unique for two reasons. First, the airline industry is part of the broader transportation infrastructure -- the very veins and arteries of the nation -- essential for commerce, communications and national defence. Thus, there is a manifest public policy in having a strong, healthy airline industry. Second, the airline industry has a chronic long-term propensity to price its product below fully allocated cost, a tendency much exacerbated by deregulation.

These unique policy and economic characteristics of air transport may warrant a unique bankruptcy policy with respect to it. However, recognize the trade off. Expedited bankruptcy procedures may on the one hand enhance the financial well being of the carriers not in Chapter 11. On the other, it will expedite the process of industry consolidation and concentration.

- 2 (a) *Why are airlines that are entering Chapter 11 confronting such difficulty in reorganizing successfully?*

Answer: The carriers entering Chapter 11 have typically been in miserable economic condition when they entered, usually with one foot in the grave. Moreover, each competing carrier usually meets the lowest price offered in the market, irrespective of comparative costs, so as to preserve market share and avoid losing more money by maintaining its price at its previous level. Such behavior is individually rational with

respect to each individual carrier's options, but is collectively irrational viewed from the perspective of the industry as a whole.

*2 (b) Do you have any suggestions for substantive bankruptcy law changes that would be fair to both debtors and creditors and yet help financially troubled airlines to emerge successfully from bankruptcy?*

Answer. Since existing management has shown itself unable to manage the company successfully, require that any carrier which enters Chapter 11 to have a change of top management. Fewer carriers will seek Chapter 11 protection if that were the law.

*3. You refer in your written submissions to "the bankruptcy laws, which cause airlines to linger on in Chapter 11 with one foot in the grave." (page 107) You advocated a time limit -- perhaps nine months -- for carriers to remain in Chapter 11. (page 109)*

*(a) Will you explain why it is undesirable for airlines to remain in bankruptcy for extended periods of time.*

Answer. Carriers in Chapter 11 need not service pre-existing debt, a sizeable proportion of operating expenses for most airlines these days. They therefore operate on an artificial cost basis and can underprice rivals not having that artificial comparative advantage. Moreover, the recovery rate for carriers entering Chapter 11 has been miserable. To date, only one airline entering Chapter 11 has emerged successfully from it. The rest were ultimately liquidated or folded into other airlines, most after a long protracted period during which their creditor's and investor's assets were devoured, they drove prices down thereby diluting yields of competing carriers, negatively impacting their economic health.

*3 (b) What impact do you anticipate a time limit on carriers remaining in Chapter 11 would have on whether airlines succeed in reorganization or face liquidation?*

Answer. The truth is, most carriers entering Chapter 11 are liquidated eventually under the current law. A specified time requirement would provide euthanasia for terminal patients, or force radical reconstructive surgery for those which stand a chance of surviving. And again, requiring a management change would likely have a positive impact on resurrection, or serve as a significant deterrent for getting into the kind of miserable financial condition which leads carriers to enter the Chapter 11 shelter.

*4. I understand that the Computer Reservation System contracts with travel agents are written in such a way as to discourage most of them from subscribing to more than one service. Specifically subscribers are required to make a certain number of bookings on the system or face penalties. Please discuss the anticompetitive aspects of this disincentive.*

Answer. I am no expert on Computer Reservations Systems. However, I believe that Congress should direct the GAO to assess whether contractual provisions like these are anticompetitive, whether bias in CRS display has or has not been removed, and whether an excessive amount of profit is being earned by CRS vendors and their owners. I do believe that Travel Agent Commission Overrides encourage fraud and are anticompetitive, and should be made illegal.

*5. Today, every airline must either own a share of a computer reservation system or pay a high booking fee -- in effect a tax on their profits -- to their competitors who do. With*

*this as well as the difficulty of maintaining discrimination-free systems in mind, some critics propose that the airlines should be forced to divest themselves of their computer reservation systems, thus placing the industry's ticket distribution process in competitively neutral hands. What do you think?*

Answer. I once took the position that divestiture ought to be considered to remedy the abuses you have identified. I no longer do. Conceptually, the world would be a better place had private entrepreneurs invested capital in an independent CRS, developed it, gotten it off the ground, and made it successful. They didn't, and it might now be unduly inequitable to penalize the airlines which took the risk to invest the enormous entrepreneurial capital to develop and build these highly sophisticated systems by forcing divestiture of them. The real questions are whether bias remains in their display and whether exorbitant capital is being transferred from non-owning to owning airlines by pricing CRS services well above cost. If so, the less draconian remedy to divestiture is modest regulation of CRS bias and price.

6. *As you know, particularly during the mid-1980s, the Computer Reservations Systems owned by two of the major airlines were purportedly used as weapons to increase their market shares and deny other airlines equal access to potential customers. Reforms have been effected through Department of Transportation regulation, as you also know. What additional measures, if any, would you recommend.*

Answer. I would recommend no additional measures until the GAO had responded to the inquiry I recommended in my answer to Question 4.

7. *In the recent Reno Air case, the Department of Transportation threatened to recommend antitrust action to the Department of Justice if Northwest Airlines went ahead with plans for three new routes in competition with Reno, a start-up carrier. What do you believe will be the long-term significance of the Reno case?*

Answer. I applaud the DOT's successful jawboning of Northwest in the Reno Air case. Hopefully, it reflects a new era of pro-active public interest protection by the agency. Nonetheless, Congress should be concerned about two things. First, the fact that aviation policy can be changed so sharply from one Administration to the next suggests that this power needs to be removed from the Executive Branch and vested in an independent regulatory agency. I remind you that Article I sec. 8 of the Constitution vests in Congress, not the Executive, the power to regulate Interstate and Foreign Commerce. Second, the DOT lacks statutory authority to remedy the problems such as those arising in the Reno Air situation. It has no statutory weapon to prohibit predation. DOT, or the independent agency in which such regulatory power should be housed, should be given such statutory power.

8. *Some of the major carriers have reportedly engaged in deep discounting in order to drive their competitors into bankruptcy. As one airport operator has said, "at some point, aggressive competition turns a corner and becomes a curse." Whether through antitrust enforcement, reregulation or some other means, can we expect predatory and anticompetitive conduct to be brought under control in the foreseeable future?*

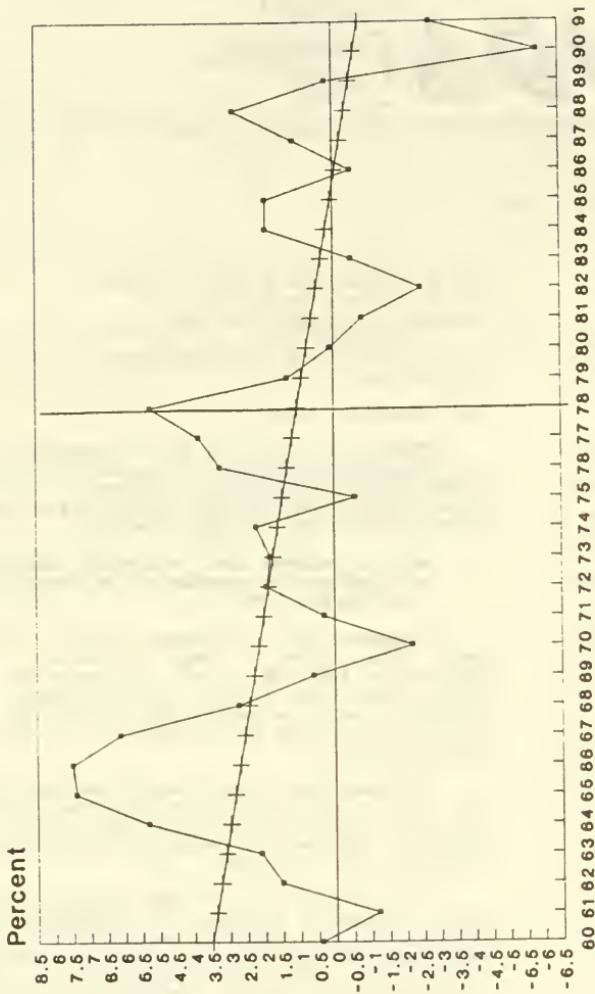
Answer. With a comprehensive legislative solution to resolve the financial crisis in the airline industry, as suggested in the 16-point program in the conclusion to my written testimony, the incentive to engage in predation will much abate. With a regulatory body with sufficient legislative remedial power and enforcement acumen, predation will be punished.

*9. What should be done to ease existing slot restrictions at major airports?*

Answer. Allow airports to engage in peak period pricing of landing fees, charging more during the times of greatest demand and less during the least congested periods. The DOT buy-sell slot rule should be repealed.

Thank you for this opportunity to respond to your questions.

# Airline Industry Net Profit Margin 1960-1991





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The Honorable Jack Brooks, Chairman  
House Committee on the Judiciary  
Subcommittee on Economic and  
Commercial Law  
B353 Rayburn House Office Building  
Washington, D.C. 20515

Dear Chairman Brooks:

Thank you for giving me the opportunity to respond to additional questions on competition in the airline industry. The following is my response to the questions connected with the Subcommittee hearing on June 9, 1993--Competition in the Airline Industry.

1. Do you believe that "passenger facility charges" assessed against consumers are a necessary "fact of life" in the 1990's?

Passenger facility charges (PFCs), like other user fees, have become a "fact of life." The fiscal necessities that led to this situation are not unlike those that have forced cities, states and other government entities across the country to look beyond traditional sources of tax revenue to cover the costs of basic services.

As widespread as their use has become, however, PFCs can unduly raise ticket prices for consumers and not only adversely affect discretionary air travel, but prevent consumers from making needed trips to visit family or attend to family business.

Overconstruction and other airport costs impose an unfair burden on airlines and consumers alike. NCL believes the FAA should be more vigilant in preventing such excesses. All PFCs should be subjected to thorough scrutiny to ensure they are necessary, reasonable and applied fairly. The FAA should ensure that any and all charges go to meet critical capacity, safety and security needs and severely restrict the imposition of PFCs to support nonessential project.

*Representing Consumers for 93 Years*

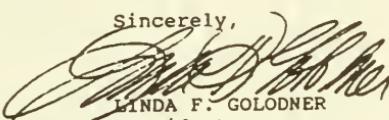
We must make sure such charges are kept as low as possibly and fully justified to support a safe, efficient and cost-effective national air transportation system.

2. What is your view of the Department of Transportation actions against alleged predatory actions of Northwest Airlines against its new competitor, Reno Air?

NCL believes that free and open competition is vital to consumer interests and central to the intent of airline industry deregulation. To that end, we support government intervention where warranted to discourage or eliminate anticompetitive behavior. The DOT's actions in the Northwest-Reno case were justified and appropriate and sent a welcome message that deregulation is not a license to engage in predatory practices that threaten competition.

Mr. Chairman, we appreciate the opportunity to testify and expand on our testimony and would be willing to clarify our position on airline industry competition if you have any further questions.

Sincerely,



LINDA F. GOLODNER  
President

LFG:gt

## MR. BROOKS' QUESTIONS FOR THE RECORD FOR MR. LORENZO

## 1. How significant is the threat of predatory pricing to new startup air carriers?

Predatory actions of a new entrant's larger competitors are probably the most significant external threat to a new entrant. These actions include both the pricing of airlines below cost as well as the addition of capacity where such expansions are not economically justified. The common thread behind each of these actions is to induce financial pressure on the new entrant such that it is "bled to death" and runs out of cash.

When a new airline is started, it typically has both relatively modest financial resources as well as a limited route structure. A new entrant airline who develops a competitive advantage through lower-cost operations or other areas should have the opportunity to enter its markets on a level playing field, letting the consumer decide which product is best. If larger, more established airlines are allowed to price their products below cost (defined as 100% break-even load factors on a fully allocated basis), the new entrant will have little ability to use its competitive advantage to gain market access. Consumers will continue with the "known" airline, especially since they often have built-in brand loyalty through their frequent flier programs. If larger airlines are allowed to use predatory prices to eliminate any potential advantage of new entrants, the ability of new entrants to gain passengers is decreased and major carriers will attempt to outlast the new carrier, then raising prices and reducing capacity when the new carrier goes away.

When a new airline begins service it also has very little route diversity, allowing the major carriers to concentrate their resources (including predatory pricing and capacity actions) on the new carrier and accepting losses in the hope of outlasting the new entrant. Such tactics are the single largest threat to any new carrier.

## 2. What factors do you believe account for the disparities in air fares which can exist on flights of similar length.

In today's airline environment, the largest disparity in fares occurs on short-to-medium haul routes. Long-haul routes present a large number of competitive options for the consumer, both with respect to direct flights as well as connection over any number of hubs. Accordingly, significant disparities in fares on similar length long-haul flights are much less common than for short-haul routes. The airline industry is highly competitive and pricing advantages among carriers with similar

products on long haul segments tend to be eliminated rapidly.

On short haul routes, however, there is a much smaller degree of competition since connections over competing hubs do not offer competitive service. This natural reduction in competition due to geographic distance has been dramatically expanded in recent years as a result of airline mergers, where a single carrier tends to dominate particular markets and in many cases has a near-monopoly position. These monopoly positions have allowed fares to rise dramatically in some markets, especially in the East.

A second significant factor in the setting of fares is the cost structure of the airline. The major full-service airlines who operate hub-and-spoke route systems have had their costs increase materially in recent years, due primarily to escalating labor and equipment replacement expenses. With the greatest ability to raise fares occurring in monopoly or near-monopoly routes, much of the cost increases is attempted to be passed on the short-haul markets.

The single most important aspect in the price disparity equation comes from whether or not alternatives to the traditional airline products exists, such as provided by Southwest airlines and what our new company ATX intends to provide. These airlines design their products with much more efficiency to generate important reductions in operating cost, and transfer those cost savings to the consumer in the form of much lower fares. The consumers, of course, respond overwhelmingly and in many cases increase travel in short-haul markets by more than 100% overnight.

## MR. BERMAN'S QUESTIONS FOR THE RECORD FOR MR. LORENZO

1. You are widely known for your participation in airline takeovers. You have testified that you only acquired carriers that were in financial trouble, such as Frontier, People's Express, and Eastern. You also participated in the bidding for at least two other airlines, National and TWA, and are reported to have made substantial profits in so-called greenmail as a consequence.

Please provide for the record the profit you realized in each of these cases.

It is totally inaccurate to characterize our failed attempts to acquire National Airlines or TWA as greenmail. These airlines were viewed as good partners for the airlines we were building at the time. In both cases, the companies was ultimately acquired by another party. Different from greenmail, we acquired stock in the companies on the open market, and sold that stock at the market price once it was clear that we would be unable to complete the merger.

Deregulation challenged the survival of small, local service carriers like Houston based Texas International. We faced expanding competition from the major airlines, as Braniff began a period of rapid growth, and American and Delta established and expanded hubs in Dallas. Other competition came from a then-unregulated low cost regional, Southwest. We felt that Texas International could not ultimately survive on its own.

The decision to pursue National Airlines came directly out of this analysis. National was a small major airline, whose growing long haul hub in Houston complemented the Houston feeder network which Texas International was operating. Because the airline also had sizable activity in both New York and Miami, it was attractive to both Pan Am and Eastern, both of whom also offered to buy the company. In fact, the Board of National Airlines never seriously entertained the TXIA bid, but instead allowed Eastern and Pan Am to bid for the company. As history recorded, Pan Am won that auction with a per-share bid of \$50. Having been shut out of the bidding process, we tendered our stock to Pan Am at the offered price, and a \$35 million profit was realized by TXIA in 1979.

It is important to note that, having failed to acquire National Airlines, Texas International turned its attention to other logical partners, which resulted in the acquisition of Continental Airlines in 1981. Like National, Continental has a long haul hub in Houston, so that the route structures of the two airlines meshed well.

The attempt to purchase TWA in 1985 was similarly a move to strengthen the competitive position of Texas Air rather than an investment strategy. At the invitation of TWA president C.E. Meyer, we entered the scene as Carl Icahn was in the process of a hostile takeover of TWA. As Time magazine reported on June 24, 1985, "Despite Icahn's denials, TWA feared that if he won control he would dismantle the company by selling off some routes, as well as landing rights and jets". By contrast, TWA and Continental had complimenting route structures, matching Continental's strength across the Pacific with TWA's major transatlantic presence.

While we believed that the merger of TWA and Continental would strengthen both companies, the board of TWA elected to accept the offer of Mr. Icahn, reversing an earlier board decision to accept our offer. Our holdings in TWA were sold in September 1985 for a small gain of less than \$20 million.

Although we failed in our merger attempts with TWA and National, we remained true to our goal of building an airline that could compete with the strong major airlines in a deregulated marketplace. The consumer has benefitted from that effort.

2. Please provide the amount of monetary and other compensation you received as a result of the agreement with SAS in which you relinquished your control of Continental.

It is important first to clarify that, since 1980, Texas Air served as the holding company for its various airline operations. At the time Continental was acquired, Texas Air held two other airlines, Texas International Airlines and New York Air. In 1982, TXIA and Continental were merged into one entity, which was renamed Continental Airlines Corporation. New York Air was combined into Continental Airlines Corporation in 1987, as were Frontier Airlines and People Express Airlines. Thus the Continental Airlines Corporation which was held by Texas Air Corporation in August 1990, when I sold my interest to SAS, was an amalgam of several different airlines.

My interest in Texas Air Corporation was through a company called Jet Capital Corporation in which I was a significant shareholder. In August 1990, SAS agreed to purchase my position in Jet Capital in its entirety. My ownership history follows:

- In 1969, I co-founded Jet Capital Corporation with an initial personal investment of approximately \$100,000.
- In August 1990, I sold my interest (49%) in Jet Capital to SAS for \$10 million.
- At the time of the sale, I also held stock in Continental Airlines in the form of management stock options. The

vested portion of these options were also sold to SAS. This sale, plus the buyout of certain management contract rights, netted another \$17 million. An amount of \$5 million of this was subsequently paid to the Continental to resolve several disputes, including a release from my no-compete provision of the prior settlement.

My long term commitment to Continental is illustrated by my Jet Capital investment history. I retained my entire position in the company when its value peaked in 1987, and sold my position in total when I stepped down as chairman in 1990.

## MR. FISH'S QUESTIONS FOR THE RECORD FOR MR. LORENZO

1. Since most airline acquisitions have been consummated through the merger of two carriers, could you explain for the record why you kept Eastern and Continental separate? Were there any antitrust considerations? Was it to make sure that Continental stayed non-union?

Each airline had strong historical market identities within their geographic regions and relatively weak identities outside of their regions.

Eastern's labor costs were too high to support their leisure-oriented route structure (a very heavy Florida presence), and were likewise too high for Continental. Any logic associated with operating the airlines as a single carrier was subordinated to the needs of stabilizing Eastern's financial performance through a restructuring of its costs.

Continental already had significant complexities associated with managing a diverse fleet of aircraft associated with the integration of People Express, Frontier and New York Air. To combine the operations of Continental and Eastern would have added to these management hurdles, as it was expected to take a few years to fully manage the integration of Continental's diverse aircraft.

2. The Bankruptcy Examiner's Report on the Eastern Air Lines case contains the following paragraph:

"A close examination of Texas Air Corporation dealings with Eastern demonstrates how Lorenzo has implemented an overall strategy to strip key component parts from Eastern for the purpose of transferring those assets to the rest of the Texas Air family. These actions have diminished the value of Eastern while enriching sister subsidiary Continental and the parent company, Texas Air."

Could you please comment on this observation in the Examiner's Report?

Like many well-publicized issues at Eastern, the review of the Examiner involved relatively complex business issues that do not lend themselves well to short excerpts and quotes so often promulgated by unions and other parties. Only an in-depth analysis of what the Examiner discovered and why transactions were entered into looking at all sides of the equation can properly address such issues. Suffice it to say that while I was not intimately familiar with each and every transaction, at all times we tried to ensure full-independent reviews from third-party sources as well as review by independent directors of the boards of the respective corporations. There was never any desire other than to improve the airlines' cost and revenue competitiveness and we were always careful to ensure that neither airline benefitted at the expense of the other. This, of course, did not stop the Examiner from concluding that claims of preferential transfers could not at least be submitted in an attempt to obtain more value for Eastern's creditors. The observation that Eastern was diminished in value by these transactions is false and out of context.

As proof of how careful one must be in drawing conclusions from short excerpts is the attached letter from the Examiner to Speaker Tom Foley for the same exact purpose as this response to the quoted paragraph. All we at Texas Air ever tried to do was to rebuild Eastern into a viable competitor with a chance for a future. If it was, in fact, our intent to simply liquidate assets we would not have made such decisions as selling New York Air's shuttle operation instead of Eastern's when the Justice Department required Texas Air to dispose of one shuttle in the Northeast Corridor. We took actions which allowed Eastern to pursue an aggressive business plan while providing the company the financial wherewithall to compete effectively.

3. Under present conditions, including incumbent airline control of landing rights, frequent flyer programs and the computer reservations systems, new entry into the airline business -- which has been called "the oxygen of competition" -- appears unlikely to be successful. These barriers to entry confront your proposed new airline. How do you intend to surmount them?

While there is no debating that some significant barriers to entry do exist, it is not accurate to conclude that new entry has little likelihood for success. Recent new entrants such as Reno Air, Kiwi International and Morris Air all have shown success through profitable operations and growth.

Certain barriers to entry are artificially borne from public policy. It is the role of the government to ensure that policy is not established that gives an unfair advantage to one business over another. Limiting airport access by grandfathering landing "slots" to incumbents creates an unlevel playing field, and is also not in the public best interest. Scrutiny of antitrust behavior on the part of incumbents toward new entrants, whether through CRS control or other predatory actions, will limit other artificial barriers. New startup airlines must rely on the government for a fair competitive battlefield.

The more important barriers to entry come from the marketplace, and carriers that overcome these barriers will succeed. As we stated in our written testimony, there is disparity between short haul markets in the Eastern United States compared with similar markets in the west. Western markets have greatly expanded ridership has a result of low cost new entrants. Presumably, these carriers are providing consumers what they want. In the east, where no low cost new entrant has entered short haul markets and fares have risen, ridership has fallen as consumers seek alternate modes. It is fair to state that demand for the traditional airline product, featuring hub-oriented service and higher fares, no longer matches the seats supplied. Meanwhile, efficient short haul airlines such as Southwest enjoy

profitable double-digit growth each year.

We are confident of our ability to be financially successful because we believe that we will deliver a product that the consumer is demanding. While traditional airlines have developed frequent flyer programs and CRS systems to gain market share, these have added to the cost of an airline seat. Similarly, the increased cost of airlines have forced them to evolve megahub route structures. By focusing on a non-hub route structure, and without many high cost marketing programs, a low cost product can be delivered to the customer. This alternative transportation product has been proven popular in the west, and we intend to bring that type of consumer value to the east.

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The Honorable Thomas F. Foley  
Speaker of the House  
U.S. House of Representatives  
Washington, D.C. 20515

Dear Mr. Speaker:

You have before you the question of overriding President Bush's veto of H.R. 1231, the proposed blue ribbon investigation of Eastern Air Lines. Having spent the last eleven months as the court-appointed Examiner in the Eastern Airlines' bankruptcy, I can only urge that you not create a blue ribbon panel. We are on the verge of resuscitating Eastern and, in my view, a blue ribbon panel will be disastrous to that effort, to say nothing of duplicating ongoing court efforts.

When I was appointed Examiner, I was given a broad mandate to protect the public with regard to the Eastern reorganization. I wish to emphasize that I do not represent Texas Air or Mr. Lorenzo any more than I represent Mr. Copeland or ALPA. I have one constituency and that is the many interests that intersect in Judge Lifland's Court: creditors, preferred shareholders, employees, retirees, and elderly folks from New York and Atlanta who can visit their children only by buying a low fare ticket on Eastern Air Lines.

There are a number of reasons why H.R. 1231 is bad legislation.

1) As my report (Vol. 1, pp. 40-48) shows: the unions have been unwilling to face up to the reality of hard collective bargaining in the hope that some outside body would rescue them. First, it was Ueberroth, then it was Ritchie, then it was H.R. 1231. When the Examiner urged the pilots to go back to work to maintain their jobs and seniority and continue to negotiate from the inside, he was accused of a "sell-out" to Lorenzo. When Jack

Bavis, Chairman of the Eastern Pilots' Master Executive Council came to the conclusion that the only way to save the pilots' jobs was to return to work, he was removed from office and brought up on charges. (The charges were later dropped). It was only after H.R. 1231 was vetoed that the pilots and management got back to the bargaining table. Based on reports currently available to me, the negotiations have been inching along toward agreement. H.R. 1231 would reverse this process, create a further straw for the unions to clutch at, and make it impossible for the parties to settle.

2) The Examiner's team (15 lawyers and a large support staff) spent more than six months looking at the various asset transfers; no Commission can do this job in 45 days.

3) H.R. 1231 undermines the doctrine of separation of powers. The transactions which the panel would examine are sub judice in every respect; the panel would cover precisely the same ground. The Bankruptcy Court and the Examiner are objectively and fairly discharging their statutory obligations. It would therefore be an unwarranted legislative interference with the judicial process for the panel envisioned by H.R. 1231 to proceed as proposed.

4) The creation of a second forum outside the judicial process to resolve Eastern's future creates uncertainty for an enterprise that no longer has the ability to withstand such shocks; it could therefore so disrupt Eastern's business and its ability to sell tickets as to make its continued viability as an air carrier untenable. This would result in the loss of jobs held by Eastern's present employees, some 17,000 people; destroy the pensions and health and medical benefits of its retired employees, some 12,000 people (mostly union members); and deprive the travelling public of yet another air carrier.

I am equally concerned that my report to the Court of last week has been misinterpreted in the press. Lest this report be improperly referred to in the forthcoming debate, I want to make sure that certain facts are clear.

I did not find that Texas Air had improperly diverted assets from Eastern. Instead, I set forth the grounds on which such a claim could be asserted. I did not make a judgment as to the validity of such a claim or its likelihood of success. In fact, my report noted that Texas Air had substantial defenses to any such claim, and, in my opinion, Texas Air could very well prevail

in any such litigation. My report stated that any legal action seeking recovery would have to plough new legal ground.

In short, as I stated in Court last Thursday, I did not find on the merits against Eastern, Continental or Texas Air. On the contrary, I issued the report contemporaneous with a settlement with Texas Air in an attempt to demonstrate that the settlement was fair, reasonable and adequate and in the best interests of Eastern. I further told the Court, "Maybe Texas Air and Continental would have won all twelve of the disputed issues, maybe six, maybe three, maybe none." Any legal judgment of wrongdoing by Eastern, Continental or Texas Air would have taken years of litigation with uncertain likelihood of success.

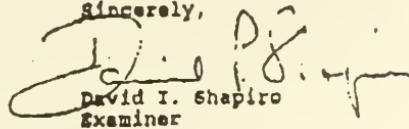
Another fact that should be firmly before the Congress involves the settlement with Texas Air. The settlement is not an admission of liability by Texas Air. Rather, it is an agreement between Texas Air and the Examiner as to what is needed to assure the economic viability of Eastern Air Lines. I frankly do not believe we could have gotten anywhere near the settlement, and its clear benefit to Eastern, unless Texas Air was committed to see Eastern through to a return to economic health. I therefore believe that that agreement demonstrates Texas Air's commitment to the future of Eastern.

Finally, whatever merit there is to the claims of "conflict of interest" and "self-dealing", the Examiner has proposed that Eastern's reorganization plan contain provisions (such as, for example, a special independent committee of outside directors) for monitoring all intercorporate transactions between Eastern and Texas Air and its affiliates which are outside the regular course of business and have a value in excess of \$500,000. Accordingly, whatever concerns that continue to exist on this score will be dealt with in the Bankruptcy Court when it comes time for the Court to consider whether or not it should approve Eastern's plan of reorganization.

I do not believe that H.R. 1231 can do any good; it will, instead, do a great deal of harm. The bitterness between management and the unions should not be allowed to determine Eastern's fate. I therefore ask the Congress to permit the bankruptcy process to complete the remaining steps necessary to the successful reorganization of Eastern. I ask the Congress to act

out of concern for the employees, retirees and members of the general public who depend on the future existence of Eastern. I ask the Congress not to enact H.R. 1231.

Sincerely,



D. I. Shapiro

David I. Shapiro  
Examiner



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